No. 15898

United States
Court of Appeals
for the Ninth Circuit

ARTHUR V. MORGAN and DOROTHY O. MORGAN, Petitioners.

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court of the United States

Phillips & Van Orden Co., Fourth and Berry Sts., San Francisco, Calif.—4-4-58

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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

Transcript of Proceedings—(Continued):

NAMES AND ADDRESSES OF ATTORNEYS

LEONARD B. HANKINS,
4014 Long Beach Boulevard,
Long Beach 7, California,

Attorney for Petitioners.

CHARLES K. RICE,
Assistant Attorney General,

LEE A. JACKSON,
Attorney,

Department of Justice,
Washington 25, D. C.,

Attorneys for Respondent.

The Tax Court of the United States

Docket No. 56621

ARTHUR V. MORGAN and DOROTHY O. MORGAN, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DOCKET ENTRIES

1955

Mar. 3—Petition received and filed. Taxpayer notified. Fee paid.

Mar. 4—Copy of petition served on General Counsel.

Mar. 3—Request for Circuit hearing in Los Angeles, Calif. filed by taxpayer. 3/8/55—Granted.

Apr. 29—Answer filed by General Counsel.

May 3—Copy of answer served on taxpayer—Los Angeles, Calif.

Jun. 25—Motion to withdraw George A. Hart, Jr. and M. B. Kambel, as counsel, filed. Granted 6/25/56.

Jun. 25—Entry of appearance of Leonard B. Hankins, as counsel filed.

1956

Oct. 19—Hearing set Jan. 7, 1957, Los Angeles, Calif.

1957

Jan. 11—Trial had before Judge Atkins on merits. Stipulation of Facts with exhibits 1-A thru 6-F, filed at hearing. Petitioner's brief due 2/25/57, Respondent's brief due 3/27/57, Petitioner's Reply due 4/26/57.

Feb. 1—Transcript of Hearing 1/11/57 filed.

Feb. 25—Brief for Petitioner filed. Served 2/25/57.

Mar. 27—Brief for Respondent filed. Served 3/28/57.

Apr. 25—Reply Brief for Petitioner filed. Served 4/25/57.

Oct. 17—Findings of Fact and opinion filed. Judge Atkins. Decision will be entered for the respondent. Served 10/18/57.

Oct. 17—Decision entered — Judge Atkins. Served 10/21/57.

1958

Jan. 7—Petition for review by U. S. Court of Appeals, 9th Circuit, filed by petitioner.

Jan. 7—Proof of service filed.

Jan. 7—Designation of contents of record on review with proof of service, thereon.

[Title of Tax Court and Cause.]

PETITION

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Ap:LA:AA-EWM 90-D ICA) dated

December 6, 1954, and as a basis of their proceeding allege as follows:

1. Petitioners are individuals whose principal residence is 4400 Myrtle Avenue, Long Beach 7, California. The return for the period here involved was filed with the Collector of Internal Revenue for the Sixth District, Los Angeles, California.

2. The notice of deficiency was mailed to petitioners on December 6, 1954. Attached hereto and marked Exhibit A is a copy of said notice, together with pages 1 and 2 of the statement which accompanied the notice.

3. The deficiency as determined by the Commissioner is in income taxes for the calendar year 1950 in the amount of $4,076.40, of which $3,952.82 is in dispute.

4. The determination of the tax set forth in the said notice of deficiency is based upon the following error:

In determining the tax liability of petitioners for the calendar year 1950, the Commissioner erroneously included in the taxable net income of Art Morgan Motor Company, a partnership, for the period ended December 31, 1950, an amount of $15,764.32 in respect of a finance reserve maintained by Farmers and Merchants Bank of Long Beach and applicable to said partnership. Upon the basis of the inclusion of said amount in the taxable income of the partnership, the Commissioner erroneously increased the taxable income of petitioners

for 1950 by the amount of $11,823.24, being 75% of the addition to the partnership's income in accordance with petitioners' 75% interest in the partnership.

5. The facts upon which petitioners rely as the basis of this proceeding are as follows:

(a) Art Morgan Motor Company was a partnership organized January 7, 1950 in which Arthur V. Morgan owned a 75% interest. Said partnership engaged in the retail automobile business and sold automobiles for cash and on conditional sales contracts.

(b) During the taxable period ended December 31, 1950 conditional sales contracts received by said partnership were simultaneously assigned at a discount to Farmers & Merchants Bank of Long Beach, California, with recourse.

(c) The full amount of the discounts was excluded from the income of the partnership; only the net amount of cash received on each contract was recognized as income.

(d) The Farmers & Merchants Bank followed a practice of setting aside as a "reserve" a portion of the amount by which conditional sales contracts were discounted upon assignment, said portion being subject to possible future payments to the partnership; however, there was no written agreement obligating the bank so to do, or obligating it to make any payments to the partnership from such reserve.

(e) It was customary for the bank to make payments to Art Morgan Motor Company in respect of this reserve at such times as and to the extent the accumulations therein exceeded the sum of 10% of contract balances and 100% of delinquent or other accounts which might to the bank appear questionable.

(f) Any interest of the partnership in the funds represented by such reserve was absolutely contingent upon the bank receiving collections on the contracts in due course, and no right whatsoever, either ultimately or currently, in or to the reserve accrued to the partnership prior to the time amounts were paid to it by the bank.

(g) The income tax return of petitioners for the year here involved was duly filed on or before March 15, 1951 with the Collector of Internal Revenue, Sixth District, Los Angeles, California.

(h) The notice of deficiency was mailed as alleged under 2 above.

Wherefore, petitioners pray that this Court may hear the proceeding and determine that there is no deficiency in excess of $123.58 due from petitioners for the calendar year 1950.

/s/ GEORGE A. HART, JR.,
/s/ M. B. KAMBEL,
Attorneys for Petitioner.

Of Counsel:

BALL, HUNT AND HART.

Duly Verified.

EXHIBIT "A"

U. S. TREASURY DEPARTMENT

Internal Revenue Service
Regional Commissioner
1250 Subway Terminal Building
417 South Hill Street
Los Angeles 13, California

Dec. 6, 1954

In Replying Refer to Ap:LA:AA-EWM 90-D ICA.

Mr. Arthur V. Morgan and
Mrs. Dorothy O. Morgan
Husband and Wife
4400 Myrtle Avenue
Long Beach 7, California

Dear Mr. and Mrs. Morgan:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1950 discloses a deficiency of $4,076.40, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Colum-

bia in which event that day is not counted as the 90th day. Otherwise, Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute, in duplicate, the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, 1250 Subway Terminal Building, 417 South Hill Street, Los Angeles 13, California. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earliest.

Very truly yours,

T. COLEMAN ANDREWS,
Commissioner of Internal
Revenue,

By H. L. DUCKER,
Special Assistant, Appellate
Division.

Enclosures:

Statement

Form 1276

Agreement Form

Ap:LA:AA-EWM
90D:ICA

STATEMENT

Mr. Arthur V. Morgan and
Mrs. Dorothy O. Morgan
(Husband and Wife)
4400 Myrtle Avenue
Long Beach 7, California

Tax Liability for the Taxable Year
Ended December 31, 1950

	Deficiency
Income Tax	$4,076.40

In making this determination of your income tax liability, careful consideration has been given to your protest dated May 19, 1954, and to the statements made at the conferences held on September 30, 1954 and October 14, 1954.

A copy of the letter and a copy of this statement have been mailed to your representatives, Mr. M. B. Kambel and Mr. A. C. Hauck, Jr., 120 Linden Avenue, Long Beach 2, California, in accordance with the authorization contained in the power of attorney executed by you.

Year 1950

Adjustments to Net Income

Net income disclosed by the amended return	$ 8,656.68
Unallowable deductions and Additional income:	
(a) Adjustment of partnership income from Art Morgan Motor Company	13,454.49
(b) Adjustment of interest income	3,663.80
(c) Disallowance of deduction for note expense	798.00
(d) Disallowance of deduction for interest expense	1,250.00
(e) Disallowance of deduction for automobile expense	875.00
Total	$28,697.97
Nontaxable income and Additional deductions:	
(f) Adjustment of partnership loss from B&B Motor Sales	461.30
Net income as revised	$28,236.67

Year 1950 (Continued)

Explanation of Adjustments

(a) Your partnership income from Art Morgan Motor Company is increased $13,454.49. Computation of adjustment is shown below:

Ordinary net income of Art Morgan Motor Company partnership as disclosed by the return, Account No. 8858128	$14,764.37
Add:	
(1) Income from sales of Conditional Sales Contracts	$15,764.32
(2) Adjustment of deduction for rent	500.00
(3) Disallowance of purchase deduction for automobile	1,675.00
Ordinary net income as revised	$32,703.69
Your 75% partnership interest	$24,527.77
Partnership income from Art Morgan Motor Company shown on your return	11,073.28
Increase in partnership income	$13,454.49

(1) In determining the correct distributable income from Art Morgan Motor Company, it is held that the gross selling price of the Conditional Sales Contracts, sold to the Farmers and Merchants National Bank of Long Beach, California, constitutes income in the year sold under the provisions of section 22(a) of the Internal Revenue Code (1939). Further, it is held that the amount which you seek to exclude from the partnership's gross income ($15,764.32) is not a deductible item under any provision of the Internal Revenue Code (1939).

[Endorsed]: T.C.U.S. Filed March 3, 1955.

[Title of Tax Court and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, R. P. Hertzog, Acting Chief Counsel, Internal Revenue Service, and for answer

to the petition filed by the above-named petitioners, admits and denies as follows:

1, 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits that the deficiency as determined by the Commissioner is in income taxes for the calendar year 1950 in the amount of $4076.40, but denies the remaining allegations of paragraph 3 of the petition.

4. Denies the allegations contained in paragraph 4 of the petition.

5 (a). Admits the allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) Admits that during the taxable year ended December 31, 1950, the partnership assigned and sold conditional sales contracts to the Farmers and Merchants Bank of Long Beach, California; but denies the remaining allegations of subparagraph (b) of paragraph 5 of the petition.

(c) Admits that the partnership did not report as income the gross sales price received on the sale of conditional sales contracts, but has no information or belief on the matter sufficient to enable him to answer the remaining allegations as contained in subparagraph (c) of paragraph 5 of the petition and hence denies the same.

(d) Respondent has no information or belief on the matter sufficient to enable him to answer the allegations of fact, if any, set out in subparagraph

(d) of paragraph 5 of the petition and hence denies the same.

(e) Respondent has no information or belief on the matter sufficient to enable him to answer the allegations of fact, if any, set out in subparagraph (e) of paragraph 5 of the petition and hence denies the same.

(f) Denies the allegations contained in subparagraph (f) of paragraph 5 of the petition.

(g) Admits the allegations contained in subparagraph (g) of paragraph 5 of the petition.

(h) Admits the allegations contained in subparagraph (h) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation contained in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the determination of the Commissioner be sustained.

/s/ R. P. HERTZOG, REM,
Acting Chief Counsel,
Internal Revenue Service.

Of Counsel: Melvin L. Sears, Regional Counsel, E. C. Crouter, Assistant Regional Counsel, R. E. Maiden, Jr., Special Assistant to the Regional Counsel, Harold W. Vestermark, Attorneys, Internal Revenue Service.

[Endorsed]: T.C.U.S. Filed April 29, 1955.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It is stipulated that the following facts may be received in evidence without further proof; provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts stipulated; and provided, further, that both parties to this stipulation reserve the right to object to the materiality and relevancy of any of the facts herein stipulated.

1. The petitioners are husband and wife residing at 4400 Myrtle Avenue, Long Beach, California. Their joint income tax return for the calendar year 1950 was filed with the Collector of Internal Revenue for the 6th District of California on or before March 15, 1951.

2. Arthur V. Morgan, the petitioner herein, and Frank D. Lortscher formed a partnership doing business as Art Morgan Motor Company (hereinafter referred to as the partnership) in Long Beach, California, on January 7, 1950. The petitioner held a 75% interest, and Frank D. Lortscher held a 25% interest throughout the taxable period in question.

3. The partnership filed an income tax return for the taxable period January 7, 1950, to December 31, 1950, with the Collector of Internal Revenue for the 6th District of California.

4. The partnership's books and records were maintained on the accrual basis of accounting.

5. The partnership was actively engaged in the purchase and retail sale of used automobiles.

6. A large number of automobiles sold by the partnership were sold pursuant to conditional sale contracts (hereinafter referred to as Contracts or Contract), the terms of which are set forth in Exhibit 1-A attached hereto. Exhibit 1-A is a document with two sides.

7. In all transactions pertinent herein, the partnership assigned the Contract to the Farmer's and Merchant's Bank of Long Beach, California (hereinafter referred to as the Bank).

8. From January 7, 1950, to July 1, 1950, the partnership assigned the Contracts to the Bank pursuant to both the terms of the assignment captioned "Seller's Guaranty and Assignment (With Recourse)" in Exhibit 1-A and the terms of an oral agreement which included the terms set forth in paragraph 10 of Exhibit 2-B attached hereto.

9. From July 1950, and throughout the remainder of the taxable period in question, the partnership assigned the Contracts to the Bank pursuant to both the terms of the assignment captioned "Seller's Warranty of Title and Assignment (Without Recourse)" in Exhibit 1-A, and the terms of the written agreement, attached hereto as Exhibit 2-B.

10. The following example is typical, except for

the sums, of the Contracts entered into by the partnership during the taxable period in question:

1. Cash Purchase Price	$2,795.00
2. Sales Tax	83.85
3. Total Cash Purchase Price	2,878.85
4. Less: Down-payment	1,645.85
5. Unpaid Cash Purchase Price	1,233.00
6. Add: Motor Vehicle Tax	40.00
7. Unpaid Balance	1,273.00
8. Add: Time Price Differential (Finance Charges or Interest)	143.15
9. Contract Balance	$1,416.15

11. During the taxable period in question, the entries to the Reserve Account on the books of the Bank were recorded by the partnership in a memorandum account; the partnership did not record them in a general ledger account, nor did it reflect them in any of its financial statements.

12. The Bank informed the partnership of entries to the Reserve Account and periodically sent the partnership statements showing the balance in the Reserve Account.

13. During the taxable period in question, some of the purchasers in the Contracts which the partnership assigned to the Bank paid off the Contract prior to its normal maturity date, and, accordingly, under applicable State law, to-wit, Section 2892 of the California Civil Code, were not obliged to pay the entire sum designated "Time Price Differential" in item 7 of Exhibit 1-A, but only a lesser sum. In these circumstances the Bank debited

the Reserve Account for a portion of the sum that was no longer due from the purchaser.

14. The following schedule shows a) the names of some purchasers in conditional sale contracts assigned by the partnership to the Bank, b) the amount credited by the Bank to the Reserve Account upon the assignment to it of each of the Contracts, and c) the amount debited by the Bank to the Reserve Account upon the payoff by the purchasers of the Contract prior to its normal maturity date:

(a)	(b) Credits to Reserve Account		(c) Debits to Reserve Account	
Name of Car Purchaser	Date	Amount	Date	Amount
Finley	1/21/50	$ 29.90	2/17/50	$ 19.90
Williams	3/27/50	15.40	6/ 3/50	2.20
Barker	6/ 1/50	106.00	6/15/50	88.32
McConnell	5/27/50	49.35	7/20/50	30.00
Barrett	6/20/50	52.24	6/29/50	52.24
Welch	4/14/50	84.21	8/10/50	56.01
Van Meter	7/14/50	50.80	8/16/50	37.53
Kennedy	8 /2/50	107.57	8/18/50	94.37
Schuler	8/ 4/50	211.55	8/29/50	153.40

This schedule is merely illustrative and does not set forth every instance during the taxable period in question where the Reserve Account was debited upon the payoff by the purchasers of the Contract prior to its normal maturity date.

15. During the taxable period in question, the credit balance in the Reserve Account never exceeded 10% of the then aggregate unpaid balances of the Contracts assigned by the partnership to the Bank, and the Bank was not required to, and did

not, make any payments to the partnership in pursuance of the terms of the agreement contained in paragraph 10 of Exhibit 2-B.

16. During the taxable period in question, the credits to the Reserve Account totaled $16,895.08, and the debits thereto totaled $1,130.76, leaving a credit balance of $15,764.32.

17. The partnership did not report as taxable income for the period in question any of the credits to the Reserve Account or any of the $15,764.32 credit balance therein; nor did it report any of the debits as a deduction.

18. In determining the deficiency in question, the respondent increased the partnership's taxable income for the taxable year 1950 by the sum of $15,764.32 representing the credit balance in the Reserve Account as of the end of the taxable year 1950.

19. The partnership did not claim a bad debt deduction for the taxable period in question.

20. The Bank did not give any consideration to the fair market value of any Contract in purchasing it from the partnership.

21. At all times material herein, the Bank was financially sound and able to pay any amount due to the partnership.

22. Attached hereto as Exhibit 3-C is a copy of the Partnership return for the taxable year 1950.

23. Attached hereto as Exhibit 4-D is a copy of

the petitioners' income tax return for the taxable year 1950.

24. Attached hereto as Exhibit 5-E is a copy of the Petitioners' amended income tax return for the year 1950.

25. Attached hereto as Exhibit 6-F is Section 2892 of the California Civil Code which was in effect throughout the taxable period in question.

/s/ LEONARD B. HANKINS,
Counsel for Petitioners.

/s/ JOHN POTTS BARNES, ECC,
Chief Counsel, Internal Revenue Service, Counsel for Respondent.

[Endorsed]: T.C.U.S. Filed Jan. 11, 1957.

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29 T. C. No. 9

Tax Court of the United States

Arthur V. Morgan and Dorothy O. Morgan, Petitioners v. Commissioner of Internal Revenue, Respondent.

Docket No. 56621. Filed October 17, 1957.

FINDINGS OF FACT AND OPINION

Amounts retained by the purchaser of an automobile dealer's deferred payment contracts and credited to a reserve account on the books of the purchaser, held to be accruable income to the dealer in the year of sale of the contracts even though the amount of the reserve at the close of the year was not sufficient to allow the dealer to demand pay-

ment of any part thereof. Shoemaker-Nash, Inc., 41 B.T.A. 417, and Albert M. Brodsky, 27 T.C. 216, followed.

Leonard B. Hankins, Esq., for the petitioners.

Joseph G. White, Jr., Esq., for the respondent.

Atkins, Judge:

The respondent determined a deficiency in income tax for the calendar year 1950 in the amount of $4,076.40. The petitioner Dorothy O. Morgan is a party only by reason of having signed the joint income tax return for the year 1950.

The respondent made several adjustments to the reported income in determining the deficiency. The only issue is whether an automobile dealer partnership, of which the petitioner Arthur V. Morgan was a member, realized income through credits to a reserve account on the books of a bank to which the partnership assigned conditional sales contracts.

Findings of Fact

Some of the facts were stipulated and as so stipulated are incorporated herein by this reference.

The petitioners are husband and wife, residing at Long Beach, California. Their joint income tax return for the calendar year 1950 was filed with the collector of internal revenue for the sixth district of California. The petitioner Arthur V. Morgan will hereinafter be referred to as the petitioner.

The petitioner and Frank D. Lortscher formed a partnership doing business as Art Morgan Motor Company (hereinafter referred to as the partnership) in Long Beach, California, on January 7,

1950. The petitioner held a 75 percent interest and Lortscher held a 25 percent interest. The partnership kept its books and returned its income on an accrual method of accounting. It filed an income tax return for the taxable period January 7, 1950 to December 31, 1950, with the collector of internal revenue for the sixth district of California.

The partnership was actively engaged in the purchase and retail sale of used automobiles. A large number of automobiles were sold under conditional sales contracts. In all such sales the conditional sales contracts were simultaneously assigned by the partnership to Farmers & Merchants Bank, Long Beach, California, hereinafter referred to as the bank.

The forms used in the making of conditional sales were furnished by the bank to the partnership. In all conditional sales contracts purchasers agreed to pay the amount designated therein as the "Contract Balance," which is made up of the several items set forth in the example given below. The purchaser agreed to pay the amount of the contract balance in equal successive monthly installments at an office of the bank. The contracts provided that title to the car should remain in the dealer until all payments were made and all conditions of the contract were complied with. Two forms of assignment were used by the partnership in assigning the contracts to the bank. Under one form the assignment was made "with recourse" and the other was made "without recourse."

From January 7, 1950 to July 1, 1950 the part-

nership assigned contracts to the bank under the form which bore the caption "With Recourse" and from July 1950 until the end of the year it assigned contracts under the form designated "Without Recourse." Both forms of assignment during the year 1950 were made subject to an additional agreement between the partnership and the bank which contained the following provisions:

4. Evidence of registration showing the Bank as legal owner must accompany all contracts submitted for purchase.

* * * * *

6. Notwithstanding the fact that the said contracts have been and will be assigned to Bank by Dealer without recourse, Dealer promises and agrees to repurchase from Bank contracts, including those executed or assigned on or subsequent to July 1st, 1950 on all such repossessed automobiles by paying Bank therefor the unpaid balance owing on such defaulted contracts, including all sums of principal, interest, charges due and to become due, and any and all collection and repossession costs, less a pro rata rebate of Bank's unearned charges. Dealer hereby waives the provisions of Section 2845, 2849 and 2850 of the Civil Code of the State of California.

* * * * *

10. Bank may retain from the proceeds of each contract purchased hereunder, agreed upon amounts and the accumulated total of said amounts shall be retained by Bank in a Dealer Reserve Account as security for any and all obligations of

Dealer to Bank, now or hereafter existing. Bank agrees, so long as Dealer shall not be in default to Bank and remains solvent and in the automobile business, to return to Dealer every six months, upon request, any amount in said account in excess of 10% of the then aggregate unpaid balances of said contracts, provided that before any releases are made to the Dealer that a 100% reserve is set up for all repossessions, skips and past due accounts which are more than 35 days delinquent. If this agreement be terminated or Dealer discontinues the discounting of contracts, then Bank shall retain all funds in said Reserve Account until all contracts, purchased by Bank from Dealer shall have been paid in full, whereupon, the balance if any, shall then be paid to Dealer.

11. This Agreement may be terminated at any time by either party upon notice in writing to the other, provided, however, that such termination will not impair or effect the liability or obligations of Dealer to Bank under this Agreement on account of any contract purchased or transaction originated prior to the time such notice is given.

The bank did not give any consideration to the fair market value of any contract in purchasing it from the partnership. However, the credit of the purchaser of the automobile is checked by the bank and the sale of the car does not become final until the bank approves the credit.

The following example is typical, except for the amounts, of the conditional sales contracts entered

into between the partnership and the purchasers of used cars during the year 1950:

1. Cash Purchase Price	$2,795.00
2. Sales Tax	83.85
3. Total Cash Purchase Price	2,878.85
4. Less: Down-payment	1,645.85
5. Unpaid Cash Purchase Price	1,233.00
6. Add: Motor Vehicle Tax	40.00
7. Unpaid Balance	1,273.00
8. Add: Time Price Differential (Finance Charges or Interest)	143.15
9. Contract Balance	$1,416.15

Upon assignment of a contract containing the figures in the example above set out the bank would immediately pay to the partnership the amount of $1,233.00 shown as item 5 and designated "Unpaid Cash Purchase Price." Item 6 in the amount of $40.00, representing motor vehicle tax, would be paid by the bank either to the partnership or directly to the Department of Motor Vehicles dependent upon whether the partnership or the bank cleared the title to the car. Item 8, designated as "Time Price Differential" consisted of finance charges or interest, and was variable depending upon what the partnership saw fit to charge the purchaser. At the time of assignment of contracts by the partnership the bank computed its discount at an agreed percentage of the "Contract Balance" which, in the above example, is $1,416.15. The rate of discount used in 1950 was 4 percent per year. In the above example the discount would amount

to $70.90 inasmuch as the contract was to run for a period of 15 months. In addition to the discount the bank made a flat charge of $5 on each assigned contract. The bank treated the $5 as earned discount and the $70.90 as unearned discount. The remainder of the contract balance not paid over in cash to the dealer would be credited to the dealer's reserve account provided for in the above-quoted agreement. In the example the difference between $75.90, representing the bank's discount, and the $143.15, representing the "Time Price Differential," namely $67.25, is the amount which would be so credited.

The entries in the dealer's reserve account on the books of the bank were recorded by the partnership in a memorandum account. The partnership did not record such entries in a general ledger account nor did it reflect them in any of its financial statements. The bank informed the partnership of entries made in the reserve account and periodically sent the partnership statements showing the balance in such account.

Purposes of the bank in maintaining the dealer's reserve account were to provide security for the payment of the assigned contracts and to induce the dealer to discount contracts with it. The dealer's purpose in entering into the arrangement with the bank was to secure necessary financing for its operations.

During the year 1950 some of the purchasers under contracts which the partnership had assigned

to the bank paid off the contracts prior to their normal maturity dates and accordingly under applicable state law [1] were not obligated to pay the entire

---

[1] Section 2982 of the California Civil Code (West's Annotated California Codes, vol. 11) provides in part as follows:

(c) Time price differential; limit. The amount of the time price differential in any conditional sale contract for the sale of a motor vehicle, with or without accessories, shall not exceed 1 percent of the unpaid balance multiplied by the number of months, including any excess fraction thereof as one month, elapsing between the date of such contract and the due date of the last installment, or twenty-five dollars ($25), whichever is greater, provided that such contract may provide for interest on any delinquent installment from and after the date of delinquency, and for reasonable collection costs and fees in the event of delinquency.

(d) Payment before maturity; refund credit. Any provision in any conditional sale contract for the sale of a motor vehicle to the contrary notwithstanding, the buyer may satisfy in full the indebtedness evidenced by such contract at any time before the final maturity thereof, and in so satisfying such indebtedness shall receive a refund credit thereon for such anticipation of payments. The amount of such refund shall represent at least as great a proportion of the time price differential, after first deducting from such time price differential a minimum charge of not to exceed twenty-five dollars ($25), as the sum of the periodic time balances after the month in which such contract is paid in full bears to the sum of all of the periodic time balances under the schedule of payments in the contract, both sums to be determined according to the monthly balances which would result if the indebtedness were paid according to the terms of the contract; provided, however, that the provisions of this subsection shall not impair the right of the seller or his assignee to receive a minimum

sum designated "Time Price Differential," but only a lesser sum. In these circumstances, the bank debited the reserve account for the portion of the sum that was no longer due from the purchaser.

In the above example of a 15-month contract, if the purchaser paid up the contract in six months, the bank would reduce the amount of the time price differential by the sum of $44.20 of which $22.83 would be entered in its unearned discount account and $21.37 would be charged to the dealer's reserve account.

The following schedule sets forth, with respect to some of the contracts assigned by the partnership to the bank, the date and amount of the original credits by the bank to the reserve account, and the dates and amounts of the debits to such account in instances of prepayments by the purchasers of cars:

Credits to Reserve Account		Debits to Reserve Account	
Date	Amount	Date	Amount
1/21/50	$ 29.90	2/17/50	$ 19.90
3/27/50	15.40	6/ 3/50	2.20
6/ 1/50	106.00	6/15/50	88.32
5/27/50	49.35	7/20/50	30.00
6/20/50	52.24	6/29/50	52.24
4/14/50	84.21	8/10/50	56.01
7/14/50	50.80	8/16/50	37.53
8/ 2/50	107.57	8/18/50	94.37
8/ 4/50	211.55	8/29/50	153.40

time price differential of twenty-five dollars ($25), or to receive interest on delinquent installments or reasonable collection costs and fees, as provided in subsection (c) of this section; and provided further, that where the amount of such refund credit would be less than one dollar ($1), no refund need be made.

The above schedule is merely illustrative and does not set forth all instances where prepayments were made by purchasers.

In determining whether a dealer was entitled to withdraw any amount from the reserve account the bank deducted from the amount of the reserve the full amount of the partnership's recourse liability on any delinquent accounts and repossessions. During the year 1950 the credit balance in the reserve account of the Art Morgan Motor Company, reduced on account of delinquencies and repossessions, never exceeded 10 per cent of the aggregate unpaid balances of the contracts that had been assigned by the partnership to the bank. The partnership was not entitled to receive and the bank was not required to make, and did not make, any payments to the partnership in pursuance of the terms of the agreement in paragraph 10 of the agreement above quoted. At all times material the bank was financially sound and was able to pay any amount due to the partnership.

During the taxable year the credits to the reserve account totaled $16,895.08, and the debits thereto totaled $1,130.76, leaving a credit balance of $15,764.32 at the end of the year.

The partnership did not report as income for the period in question any of the credits to the reserve account or any of the $15,764.32 credit balance therein; nor did it report any of the debts as a deduction. The partnership did not claim a bad debt deduction for the taxable year in question.

In determining the deficiency, the respondent in-

creased the partnership's income for the taxable year 1950 by the sum of $15,764.32, representing the credit balance in the reserve account as of the end of the taxable period 1950, and as a consequence increased the petitioner's distributive share of the income of the partnership. The respondent also held that the $15,764.32 item did not constitute a deductible item to the partnership under any provision of the Internal Revenue Code of 1939.

Opinion

The sole question presented is whether the amount of the credit balance in the dealer's reserve account on the books of the bank at the end of the taxable period constituted gross income to the dealer partnership in that period.

When the partnership sold an automobile under a conditional sales contract, the purchaser obligated himself to pay in installments over a specified time a contract balance which included not only the selling price of the car (after deducting the down payment) but a time price differential composed of finance charges or interest. The partnership then assigned to the bank all its right, title and interest in the contract, including its security interest in the automobile. The bank immediately paid the partnership an amount equal to the remaining unpaid purchase price of the car and credited the remainder of the contract balance, after subtracting its discount (which consisted of a flat charge and a percentage of the contract balance), to the dealer's reserve account. The partnership, in consid-

eration of such credit, guaranteed full performance of the sales contract. It would become liable as guarantor in the case of any defaults. In the case of any repossessions by the bank, the bank was to deliver the repossessed cars to the partnership and the partnership agreed to repurchase the contracts on all such repossessed automobiles by paying the bank the unpaid balance owing on the defaulted contracts, including all sums of principal, interest, charges due and to become due, less a pro rata rebate of the bank's unearned charges.

The partnership had the right to receive, every six months, upon its request, any amount in the reserve account in excess of ten percent of the then aggregate unpaid balance of contracts. Upon termination of the agreement between the partnership and the bank, the partnership was entitled to receive the amount of the reserve at such time as all contracts were paid in full.

The respondent has determined that the total credit balance in the dealer's reserve account as of the end of the taxable period constituted income to the partnership. This was the partnership's first taxable period and the total amount of the reserve at the end of the period therefore represented the net addition thereto. Under similar circumstances we have held, in a number of cases involving taxpayers who maintain their books and return their income on an accrual method of accounting, that this treatment is correct. Shoemaker-Nash, Inc., 41 B.T.A. 417; Albert M. Brodsky, 27 T.C. 216; Texas Trailercoach, Inc., 27 T.C. 575 (now on appeal

C.A. 5); and West Pontiac, Inc., 27 T.C. 749 (now on appeal C.A. 5).

The petitioners contend that our prior cases were not correctly decided, but alternatively contend that the instant case is factually distinguishable from such prior cases. They contend that there was not an unqualified obligation on the part of the bank to pay the partnership the full amount credited to the dealer's reserve, since, under the law of California, the purchaser of an automobile has a right, upon the satisfaction of his contract prior to maturity, to a rebate (or to be relieved of payment) of a portion of the time price differential, in which case a debit is made to the dealer's reserve account of a proportionate part of such time price differential. They claim that the credit is nothing more than a bookkeeping entry of an amount which may at some time become payable, that it is a mere potential liability (apparently of the bank), and that since the amount payable has not become fixed it is not properly accruable. They also contend, apparently alternatively, that the arrangement between the partnership and the bank is in the nature of a joint venture in which the parties are to share the time price differential when "earned."

The agreement between the partnership and the bank does not specifically deal with the liabilities of the parties in the event of the satisfaction of a purchaser's liability prior to maturity of his obligation, but the testimony is that in such a case the reserve is debited in the amount of a portion of the time price differential.

We see no essential difference between this case and those which we have previously decided. Here, as in such previous cases, the reserve was designed to protect the finance company and the amount therein at any particular time could redound to the partnership's benefit through discharge of its guaranty obligations to the bank. Here also the amount of the reserve in excess of a percentage of the aggregate unpaid contract balances is payable to the partnership and the partnership is entitled to the entire balance in the reserve if and when all the contracts are paid in full. Under these circumstances, we think the partnership's right to receive the net amount of the addition to the reserve during the taxable period became fixed, requiring its accrual by the partnership, under the principle of Spring City Foundry Co. v. Commissioner, 292 U.S. 182. The case of Albert M. Brodsky, supra, is closely in point, since there the dealer's reserve was made up of credits representing the difference between the bank's discount rate and the "contract carrying charge," which in this case is called the "time price differential."

We do not agree with the petitioners that the arrangement between the partnership and the bank was in the nature of a joint venture in which each was to share in the time price differential as it was "earned." Actually the bank was making a specific charge and its income from the transaction was limited to that amount. As we view the relationship between the partnership and the bank, the bank undertook an obligation to satisfy the full amount

of the contract balance, less its discount consisting of its specific charge and a percentage of the total contract balance. It satisfied that obligation by payment immediately of the remaining unpaid selling price of the car in cash to the partnership and by setting up a reserve for the balance. The amounts credited to the reserve were payable to or on behalf of the partnership in the manner described above. The obligation of the bank to the partnership was an accrued liability at that time. The mere fact that payment of the portion that went into the reserve account was postponed does not affect its accruability in the year in which the credit was made. And the possibility that subsequent prepayments by purchasers of cars would reduce the amount in the reserve does not affect the accruability since such reduction would be the consequence of a condition subsequent.

The petitioners contend that if the respondent's determination is approved the result is that they will be taxed on income which they may never receive. However, since the reserve as of the end of the taxable period has been reduced on account of prepayments of contracts during the period, it is clear that insofar as those contracts are concerned the petitioners will not be taxed on income which they will never receive. Furthermore, if any of the other contracts are prepaid during the next taxable year, debits on account thereof will serve to offset otherwise taxable income represented by credits to the reserve account.

If the partnership sustains losses on account of

its guaranty of contracts, the question then becomes one of deduction which is not involved in this proceeding. Spring City Foundry Co. v. Commissioner, supra.

The petitioners rely upon Johnson v. Commissioner (C. A. 4), 233 F. 2d 952, which reversed our decision in Blaine Johnson, 25 T.C. 123. However, here, as in our previous cases cited above, with due deference to the Court of Appeals for the Fourth Circuit, we feel compelled to adhere to our previous decisions.

Decision will be entered for the respondent.

Served and Entered Oct. 18, 1957.

Tax Court of the United States
Washington

Docket No. 56621

ARTHUR V. MORGAN and DOROTHY O. MORGAN, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed October 17, 1957, it is

Ordered and Decided: That there is a deficiency

in income tax for the calendar year 1950 in the amount of $4,076.40.

Entered Oct. 17, 1957.

[Seal] /s/ CRAIG S. ATKINS,
Judge.

Served and Entered Oct. 21, 1957.

[Title of Tax Court and Cause.]

PETITION FOR REVIEW OF DECISION OF TAX COURT

Comes now petitioners Arthur V. Morgan and Dorothy O. Morgan, and respectfully petitions for a review of the decision of the Tax Court rendered in the above entitled matter, and respectfully alleges:

I.

The above entitled proceeding involves the petitioners' income taxes for the year 1950.

The controversy relates primarily to the question of whether amounts credited to a dealer's reserve account by the finance company acquiring conditional sales contracts covering the sale of automobiles by assignment with recourse from taxpayer, an accrual basis automobile dealer, and which credits were subject to reduction pursuant to state law when a contract was paid off prior to maturity and also subject to reduction for repossession losses and where such credits were not an absolute liability of the finance company to the dealer and where the

dealer had no present right to receive money from the bank equal to these credits, or to receive any amount of money as a result of these credits during the taxable year in question, taxable as income to him in the years in which the contracts are assigned to the finance company or in the year in which these credits, if any, become payable to him under the terms of the agreement between taxpayer and the finance company.

It was the decision of the Tax Court herein that these credits to the dealer's reserve account on the books of the finance company that purchased the conditional sales contract were accruable as income to the dealer in the year of the sale of the contracts even though the amount of the reserve at the close of the year was not sufficient to allow the dealer to demand payment of any part thereof. It is the contention of the petitioners that these credits to the reserve account which represent a portion of the unearned interest are not income to the petitioners until there is some payment due petitioners under the terms of the agreement between the dealer and the finance company.

II.

The review is sought before the United States Circuit Court of Appeals for the Ninth Circuit.

III.

The petitioners at all times herein mentioned have resided and now reside in the County of Los Angeles, State of California; that they filed their income tax return for the year involved with the

Collector of Internal Revenue at Los Angeles, Sixth District of California.

That the place where petitioner resides, and the place where the office of said Collector (now Director) of Internal Revenue at Los Angeles is located is within the Circuit of the United States Court of Appeals for the Ninth Circuit, and said Court is the Court having jurisdiction of a review of the decision of the Tax Court herein under the provisions of Internal Revenue Code, Section 7482.

That the decision of the Tax Court was entered herein on October 17, 1957; that the time for filing a Petition for Review will expire January 17, 1958 (IRC 7483).

Wherefore, your petitioners pray that a review be had of the decision of the Tax Court rendered in the above entitled matter, and that upon such review said decision be reversed.

Respectfully submitted,

/s/ LEONARD B. HANKINS,
Attorney for Petitioners.

Affidavit of Mailing Attached.

[Endorsed]: T.C.U.S. Filed Jan. 7, 1958.

[Title of Tax Court and Cause.]

NOTICE OF FILING OF PETITION FOR REVIEW

To: Nelson P. Rose, Chief Counsel, Internal Revenue Service:

You are hereby notified that on January 3, 1958, Arthur V. Morgan, and Dorothy O. Morgan, the petitioners herein, filed a Petition for Review of the Decision of the Tax Court heretofore rendered herein. There is delivered to you herewith a copy of the Petition filed.

Dated: January 3, 1958.

/s/ LEONARD B. HANKINS,
Attorney for Petitioners.

Acknowledgment of Service Attached.

[Endorsed]: T.C.U.S. Filed Jan. 7, 1958.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 19, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review", including Joint exhibits 1-A thru 6-F, attached to the Stipulation of Facts, in the case before the Tax Court of the United States

docketed at the above number and in which the petitioners in the Tax Court have filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 20th day of January, 1958.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

In the Tax Court of the United States

Docket No. 56621

ARTHUR V. MORGAN, et al., Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

TRANSCRIPT OF PROCEEDINGS

Federal Building, Los Angeles, California, Friday, January 11, 1957.

The above-entitled matter came on for hearing, pursuant to notice, at 10:45 o'clock a.m.

Before: Honorable Craig S. Atkins.

Appearances: Leonard B. Hankins, Esq., appear-

ing on behalf of Petitioners. Joseph G. White, appearing on behalf of Respondent. [1]*

Proceedings

The Clerk: Docket No. 56621, Arthur V. Morgan. State your appearances, please, gentlemen.

Mr. Hankins: Leonard B. Hankins, for the Petitioner.

Mr. White: Joseph White, for the Respondent. Ready for trial.

Mr. Hankins: Ready for trial.

The Court: Mr. Hankins, do you have an opening statement?

Mr. Hankins: Yes, sir.

Opening Statement on Behalf of Petitioners

Mr. Hankins: Your Honor, this is an income tax case in which a single and familiar issue is presented. This issue is whether the portion of the finance charges which were unearned and credited by the Farmers & Merchants Bank of Long Beach, California, to whom conditional sales contracts were transferred by the Art Morgan Motor Company, a partnership, was income to the partnership in the year during which these charges were credited to the dealer's finance reserve by the bank or was the income from this, if any, to be included in the year in which the sum became payable to the partnership, pursuant to terms agreeable between the bank and the partnership.

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* Page numbers appearing at top of page of Reporter's Transcript of Record.

Most of the facts will be stipulated between [3] Petitioners and Respondent. Arthur V. Morgan, the petitioner here and Frank D. Lortscher formed a partnership doing business as Art Morgan Motor Company in Long Beach, California, on January 7th, 1950.

The petitioner held a 75 per cent interest and Frank Lortscher held a 25 per cent interest throughout the taxable period in question.

The partnership was actively engaged in the purchase and retail sales of used automobiles. The partnership's books and records were maintained on the accrual basis of accounting.

A large number of automobiles sold on conditional sales contracts, and in order to finance these sales, the partnership assigned the contracts to the Farmers & Merchants Bank of Long Beach, California.

From January 7, 1950, to July 1, 1950, the partnership assigned the contracts to the bank pursuant to both the terms of the assignment on the bank of the conditional sales contracts under the caption "without recourse," and pursuant to certain terms of an oral agreement between the partnership and the bank.

From July and throughout the remainder of the taxable period in question, the partnership assigned two partnership contracts to the bank pursuant to terms on the reverse side of the conditional sales contract under the [4] caption "without recourse," and pursuant to the terms of a written agreement which will be stipulated in evidence.

When a conditional sales contract was assigned to the bank, the bank would in most cases pay to the dealer the unpaid cash purchase price of the automobile. In other cases, if the unpaid cash price was in excess of the amount of which the bank would normally loan on the automobile, the bank would withhold the balance of the unpaid purchase price over the amount the bank would loan on the automobile. This withhold would be placed in account security by the bank and would be released by the bank when the contract was paid down a sufficient amount which the bank deemed necessary for security. The bank then split up the finance charges on its books, a portion of which was credited to the bank under "earned discount."

Another portion credited to a special reserve for losses, and the remaining portion of the reserve was credited to the Art Morgan dealers finance reserve account. The portion credited to the dealers finance reserve account was not subject to withdrawal by the dealers, but instead there were other computations made by the bank in order to determine what portion, if any, the dealer was entitled to have paid to him, any money represented by the dealers finance reserve account. Ultimate payment by the bank of any of these dealers finance reserves was in consideration [5] for the dealers guaranteeing the paper, the computations in order to determine the amount available and payable to the dealer every six months was in essence as follows:——

The Court: May I interrupt you a moment, sir? I want to speak to counsel off the record.

(Discussion off the record.)

The Court: On the record.

Mr. Hankins: The bank would compute the account and credit to the dealer's finance reserve account that portion of the finance charge of each contract which it added to the dealer's finance reserve and subtracted all deductions to this reserve account because of pay-offs of the conditional sales contract prior to maturity date by which the bank was obligated under California law to reduce the total amount of the finance charges collectible.

To this remaining balance of the dealers finance reserve account was then subtracted the balance of each contract which was past due for more than thirty-five days. The bank then computed the unpaid balances of all conditional sales contracts assigned by the dealer to the bank and if 10 per cent of these unpaid balances was less than the sum total of the dealer's finance reserve as adjusted above, then that balance was due and payable to the dealer. If the 10 per cent was greater, then nothing was payable to the dealer.

The portion of the finance charges which was [6] originally allocated to the dealer's finance reserve account is always subject to readjustment, and reductions therein accordingly reduced where conditional sales contracts were paid off prior to their maturity date. This adjustment for reduction in finance charges were made pursuant to the provisions of California law.

When the original finance charge was computed, reduced as computed, is reduced to the automobile purchaser a portion of the reduction used to decrease the bank's portion of its unearned discount and the remainder used to reduce the dealer portion of the reserve account during the taxable period in question.

The credits to the Art Morgan dealer's finance reserve account totaled $16,895.08; reductions totaled $1,130.76, leaving a credit balance of $15,-764.32.

During the taxable year in question, the credit balance of the reserve account never exceeded 10 per cent of this unpaid balance of the contracts assigned by the partnership to the bank and the bank was not required to do, and did not make any payment to the partnership pursuant to the terms of their agreement.

The partnership did not report as taxable income for the period in question any of their credits to the reserve account or any of the balance in the reserve account remaining after certain reductions in the account were made [7] by the bank, nor did the partnership report any reduction in the reserve account in its income tax return.

The applicable State law which requires a deduction of total finance charges originally appearing on conditional sales contracts is Section 2892 of the California Civil Code.

This concludes the petitioner's opening statement, your Honor.

Opening Statement on Behalf of the Respondent

Mr. White: In the beginning, your Honor, I would like to state that the assignment of the contracts from the period January 7, 1950, to July 1, 1950, was subject to the assignment in Exhibit 1-A, entitled "with recourse," and also subject to oral agreement which incorporated Paragraph 10 of Exhibit 2-B. I think counsel for the petitioner inadvertently stated it was an assignment labeled "without recourse."

As stated by counsel for the petitioner, this is a rather old and frequently occurring issue, the question of whether these credits to a dealer's finance reserve are income to the dealer — by dealer, we mean the automobile dealer at the time the bank credits this account — or whether the dealer, even though he is on the accrual basis, can wait until the bank makes a cash payment to him before reporting this as income. [8]

The Tax Court has held in favor of the respondent that it is taxable income to the dealer on accrual basis at the time the credit is made to the account.

There is a long line of cases in that regard, first of all the Blaine Johnson case which was 25 TC 123——

Mr. Hankins: Your Honor, I object. This seems to be argument which should be in brief rather than facts in the case.

Mr. White: I am doing this, your Honor, to help you follow the testimony which will come. I am not attempting to argue, but I do want the Court to

know what the picture is. I am not going into controversy except to state that they exist.

With your permission, the Blaine Johnson case is one where the Tax Court held for the Respondent and the Fourth Circuit reversed and held for the taxpayer.

In addition to the Blaine Johnson case, there have been numerous cases in the Tax Court, one of which is the Albert M. Brodsky case, a recent case in 27 TC, which again held for the Government, calling attention to the Fourth Circuit as to that previous opinion, this position was again taken by the Tax Court.

To help your Honor follow the testimony which we will have this morning, I will first submit, with permission of counsel, the stipulation of facts together with exhibits [9] attached. I might add that there are three exhibits not yet attached. They are income tax returns we haven't had time to photostat. We will do that as quickly as we can and mail them to Washington.

The Court: Very well. The stipulation will be received.

Mr. White: I think it will help your Honor if you would turn to Paragraph 10 of that stipulation and at that point you will see a paragraph which is in controversy this morning and there will be some terminology there which will be used often this morning and which we might as well acquaint ourselves with at the moment.

Paragraph 10 sets forth as a typical example, a section of the conditional sales contract employed

by this partnership, the Art Morgan Motor Company.

The Court: Paragraph 10?

Mr. White: Paragraph 10 on page 3 of the stipulation. You will notice, your Honor, the first item is "cash purchase price." There is added to that the sales tax and then the total is shown below that. Item 4 is the down payment. That down payment is subtracted from Item 3 and we have the unpaid cash purchase price. To that is added the motor vehicle tax, another total is brought down. Now, at this point we have reached one item which will be discussed often this morning, that is the unpaid balance which is Item [10] No. 7.

In this example is $1,273.00.

The next item which will be spoken of often is Item No. 8, referred to as "time price differential," which is another term for finance charge of the interest which the purchaser agrees to pay on this conditional sales contract.

The items prior thereto would be the cost of the automobile, the insurance and the taxes, such as the Motor Vehicle tax, but at this point we reach for the first time the finance charge or interest which he agrees to pay.

The Court: Now, is that the profit that the company makes out of this?

Mr. White: That will be the interest. It is not the profit that the dealer makes.

The Court: What is the name of the bank?

Mr. White: Merchants—Farmers & Merchants Bank.

The Court: Farmers & Merchants Bank. Now, as I understand these notes—are these discounted or not?

Mr. White: We will reach that in a moment.

The Court: But, in any event, that interest represents a part of the income of the bank?

Mr. White: The bank will earn a part of that. I think I had better go on to explain at this point the contract is between the purchaser of the automobile and the dealer. The bank hasn't entered at this point. The dealer and the purchaser execute this conditional sales contract, which contains [11] these terms and, as I say, Item 7 is the unpaid balance to which is added the finance charge or interest called herein "time price differential."

Another total is drawn and we have a contract balance that, again, is a crucial item in the testimony this morning. The dealer, then, takes this conditional sales contract to the bank—and whenever we refer to "bank" here, we mean the Farmers & Merchants Bank of Long Beach—where this contract is discounted by the bank, for example, the bank will discount at the rate of four and a half per cent for $100.00 in the contract balance. In that contract balance the bank will pay four and a half per cent as its discount.

I think that answers your question, your Honor, at this point, the bank takes out, so to speak, what it intends to earn on this contract.

The Court: That is four and a half per cent of what figure?

Mr. White: Roughly—let's say the contract bal-

ance. In addition to that — and here is a crucial credit question — let me correct myself. After deducting the discount from this contract balance which is the last item, No. 9, you will have a sum, for example it might be a thousand dollars. The bank does not pay the $1,000 in cash to the dealer, it withholds from that $1,000 a certain sum which we [12] refer to here as the dealer's finance reserve credit. That particular sum the bank credits to this account which has various names, I think here we call it the reserve account, and as explained by the petitioner's counsel, as the credit balance in that reserve account reaches a certain level the bank will then pay in cash to the dealer a certain sum depending on the sum that is left in the reserve account.

Now, here is where we reach argument. The petitioner's contention is: When the bank is crediting to this reserve a portion of Item No. 8 which refers to finance charge or time price differential, the Government contends that the bank credits to the reserve a portion of the contract balance and that it is a relatively insignificant with the time price differential. The bank is going to credit a certain amount to that reserve regardless of how much the time price differential is.

At this point we reach argument, and testimony will be taken this morning from the bank and I believe also from the petitioner, Mr. Morgan, to determine what was the procedure in the year in question.

I might add, while talking about the year in

question, that the partnership period here is January 7, 1950, to December 31, 1950. The taxpayer's year is a calendar year, 1950, so his income in question is for the partnership period ending December 31, 1950. It falls in that same year, [13] the taxpayers, husband and wife.

I might add also to this point, again to clarify, that the reserve account which the bank sets up on its books is, in the opinion of the respondent, security, so that in case there is a default on some contract which the bank has purchased from the dealer and the dealer cannot make good its guarantee to the bank, the bank has this reserve which it can resort to as security; in such an instance the bank would debit that reserve or perhaps first seek direct payment from the dealer, and I suppose it would prefer direct payment so that the reserve would be kept at the high level.

A second instance in which that reserve might be debited is where a purchaser on this contract pays off the contract prior to that—prior to the maturity. Under State law, he is not required to pay that entire finance charge or time price differential, he pays a lesser sum. There will then be, in that instance, a lesser sum to be collected by the bank because of reduction in the finance charges. The bank will then debit the dealer's reserve, but it is for the entire amount or a portion, which will be brought out in testimony.

And then another, a third method in which that account is debited is if the credit balance reaches a

certain level where the bank is obliged to and does make a cash payment to the dealer. [14]

In some of the cases which have come before the Tax Court, the respondent has placed in income of the dealer the credits to this reserve and allowed a reduction for the appropriate debits. In the instant case, the respondent has, instead of placing all credit in income, it has merely placed the credit balance at the end of the year in the income from the dealer in the instant case. That credit balance is approximately $15,000.

In similar cases an issue of the deduction for bad debt has been injected. We need not reach it in this case, insofar as no deduction for bad debt was, for the taxable period in question, made for the partnership.

Your Honor, that concludes the respondent's opening statement.

The Court: Very well.

Mr. Hankins: The petitioner would like to call for its first witness Mr. Russell H. Simpson.

RUSSELL H. SIMPSON

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Be seated, please, and state your full name.

The Witness: Russell H. Simpson. [15]

Direct Examination

Q. (By Mr. Hankins): Mr. Simpson, what is your present occupation?

(Testimony of Russell H. Simpson.)

A. I am assistant cashier with the Farmers & Merchants Bank.

Q. How long have you been with the Farmers & Merchants Bank? A. Twelve years.

Q. You were with the Farmers & Merchants Bank, then, in 1950? A. Right.

Q. Prior to that time? A. Yes.

Q. Do you know the procedures used by the bank in purchasing conditional sales contracts from used car dealers? A. I do.

Q. Was the procedure used in purchasing these conditional sales contracts from used car dealers the same for all dealers who had conditional sales contracts assigned to the bank? A. Yes.

Q. Were you acquainted with the operations of Mr.—strike that.

Are you acquainted with the Art Morgan Motor Company partnership? [16] A. Yes.

Q. And did the Art Morgan Motor Company assign any conditional sales contracts to the Farmers & Merchants Bank in 1950?

A. Yes, they did.

Q. Does the bank still have any of the copies of conditional sales contracts which were assigned by the Art Morgan Motor Company to the Farmers & Merchants Bank during the year 1950?

A. No, they do not.

Q. What generally does the bank do with those conditional sales contracts?

A. We have only one copy and that is the orig-

(Testimony of Russell H. Simpson.)

inal. When the account is paid out, the original is returned to the purchaser.

Q. Then, you don't have any of those records?

A. Only the ledger card which would recite the obligation of the contract.

Mr. Hankins: We have stipulated in evidence the conditional sales contract, and I would like to call that to the attention of the witness.

Q. Mr. Simpson, I direct your attention to this conditional sales contract, which has been stipulated in evidence as Exhibit 1-A, and I would also like to direct your attention to Paragraph 10, showing a typical transaction [17] setting forth sums which might appear on a conditional sales contract.

The Court: That is in the stipulation of facts?

Mr. Hankins: Yes, sir.

Q. (By Mr. Hankins): Directing your attention to the—to both of those exhibits, when a contract written on a conditional sales contract, such as Exhibit 1-A thereon of which the sums set forth in the stipulation of fact in Paragraph 10 appear and this contract covered the sale of used cars by Art Morgan Motor Company, and this contract was assigned by the Art Morgan Motor Company to the Farmers & Merchants Bank: Can you state how much money was paid on that contract to the Art Morgan Motor Company at the time the contract was assigned to the bank? A. Yes.

Q. Would you state that amount, please?

A. $1233.

Q. Now I will direct your attention to Para-

(Testimony of Russell H. Simpson.)

graph 10, line 8, and assuming the same factual situation that I gave you previously, under the two documents and the same figures appearing on both, could you state how much or how the bank handled the $143.15? A. Yes.

Q. Would you describe the procedures used by the bank [18] in handling that amount?

A. We would arrive at a charge determined by the rate that we were charging the dealer and would take that charge and subtract it from the time price differential here on line 7—on line 8, and credit the balance to the dealer's reserve account.

Q. Have you made a breakdown of these figures, the computations that the bank makes, for this $143.15? A. Yes, I have.

Q. What is the breakdown that you have computed?

A. The bank charges would be $75.90 and there would be credited to the dealer's account $67.25, to the dealer's reserve account.

The Court: Would that be the total charge that you would be making on this whole transaction?

The Witness: For the bank charges?

The Court: The bank charges would be that figure you just gave?

The Witness: That is correct, seventy-five ninety. That would be the total charge.

Mr. White: And the portion to the dealer was how much?

The Witness: $67.25.

(Testimony of Russell H. Simpson.)

Q. (By Mr. Hankins): Then, Mr. Simpson, I believe in taking your time [19] price differential, that you stated the bank would then make these allocations on its book, seventy-five ninety to the bank's share and the dealer's share $67.25 of the $143.15? A. Correct.

Q. Now, to what account in the bank is this credited?

A. Seventy dollars and ninety cents would be charged to unearned discount.

Q. Seventy dollars and ninety cents?

A. Right, five dollars would be charged to earned discount.

Q. And the dealer's share, what account was that charged to?

A. Deposited to the Art Morgan Motor Company's reserve account.

The Court: That would be credit, wouldn't it?

The Witness: Credit, that's right.

Q. (By Mr. Hankins): In other words, the $143.15 was split up, $70.90 to the bank under unearned discount, $5.00 to the bank as earned discount, and $67.25 to the dealer's finance reserve account; is that right? A. That's right.

Q. Were any of these contracts paid off prior to maturity? A. Yes. [20]

Q. About what length of time, generally, were contracts paid off?

A. Any time during the life of the contract.

Q. Any time during the life of the contract.

(Testimony of Russell H. Simpson.)

Could this contract have been paid off after six payments? A. Yes.

Q. If this contract had been paid off after six payments, would the bank make any adjustments in its records? A. Yes.

Q. What, generally, would the bank do then if it was paid off in five months, which is prior to the maturity of the contract, say, running fifteen months?

A. We would refund the unearned portion of the time sales markup.

Q. Assuming that this contract was a fifteen-month contract and it was paid off in six months, have you made any computations to show what adjustments the bank would have made to its records?

A. Yes, I have.

Q. What are those?

A. There would be a refund of unearned charges in the amount of $44.20.

Q. $44.20. That would be a reduction in this time price differential? A. Correct. [21]

Q. What else does the bank do?

A. Since the bank has refunded charges it had previously collected, they can split up that refund between that portion of the refund that the bank would charge itself and that portion that they would charge to the dealer's reserve account.

Q. Have you made the computations of what figures would be represented?

A. Yes. In this particular case, $21.37 would

(Testimony of Russell H. Simpson.)

have been charged to the dealer's reserve account and $22.83 to the bank unearned discount.

Q. Then, in essence, if this contract is paid off prior to its maturity date, then you would make a reduction to the purchaser of $44.20?

A. That's right.

Q. You would then lose of the original unearned discount of $70.90, you would lose $22.83, the bank would? A. That's right.

The Court: That means you would have earned that much less than you originally thought you would earn?

The Witness: Right.

Q. (By Mr. Hankins): Then the dealer would lose, or his earnings would be $21.37 less than the original share? A. That's right. [22]

Q. Now, Mr. Simpson, in handling these contracts at the bank, the dealer brings them in to you and you split up these reserves in this manner, as you have pointed out here. Would you ever take more of this contract for your unearned discount than is shown on the time price differential line of the contract?

A. That would not be possible.

Q. It wouldn't be possible? A. No.

Q. In other words, the dealer, then, would always have some share of this time price differential? A. That's right.

Q. Is this $67.25 that you put over into this dealer's reserve account, is that subject to the dealer's withdrawal immediately?

(Testimony of Russell H. Simpson.)

A. The dealer has no control over that account whatever.

Q. Well, the dealer—the dealer ultimately gets the full $67.25?

A. It is possible for him to get that $67.25, but you would never be able to tie it down to any one payment.

The Court: Isn't it true that if the contract went on to maturity and it was paid regularly, that in effect the dealer would get that in a particular case?

The Witness: It's possible, except I think it would [23] be more proper to say, the question being asked by counsel, that is equity in his reserve account.

The Court: In other words, what you are saying is: He doesn't get a specific amount from specific contracts, it is a matter of reserve, but my point was that if all contracts went on to maturity, certainly the fact is that in every case he would eventually get that amount?

The Witness: All paid out at maturity and not before.

Q. (By Mr. Hankins): In essence, then, you take your time price differential and the dealer and bank shares in that? A. That's right.

Q. The $67.25 that you originally put over there, is that represented by cash?

A. No, that is merely a book entry.

Q. Merely a book entry? A. That's right.

Q. Then, in order to allow the dealer to with-

(Testimony of Russell H. Simpson.)

draw anything under his contract, what subsequent computations does the bank make in order to determine what, if anything, is payable to the dealer out of an account in which these items are accumulated?

A. The bank predetermines a percentage of the dealer's contingent liability, that is to say, if all the [24] dealer's contracts totaled a million dollars, the bank would want a 10 per cent reserve. The bank would refund to the dealer anything in excess of that 10 per cent reserve after deducting from the reserve all those accounts which had more than one payment past due or unpaid repossessions.

Q. In other words, this original $67.25 of the time price differential which you put into the dealer's finance reserve account is subject to other computations before you can determine what, if any, portion of this is due the dealer; is that right?

A. Correct.

Q. It is subject to any reductions of pay-offs?

A. Right.

Q. Writing the balance down in the credit side of the dealer's reserve account by each debit to the account as a result of pay-offs? A. Right.

Q. Then, assuming that our dealer's reserve account at the end of the year was $15,764.32, then if this figure, plus your balance of the contracts on which more than one payment is past due, is in excess of the 10 per cent of this outstanding contract balances, then would you pay him any money?

(Testimony of Russell H. Simpson.)

A. May I answer that with an explanation, rather?

Actually, what we do is: We would take 100 per [25] cent reserve on all delinquent accounts, plus 100 per cent reserve on all unpaid repossessions, and subtract it from the amount of the reserve, so if we raised that figure of $10,000, for example, say that $10,000 figure——

The Court: What $10,000 figure?

The Witness: Let's say that is his dealer's reserve.

The Court: That's 10 per cent of the contract balance?

The Witness: Correct. Let's raise that. Let's say he has a contingent liability and has 10 per cent reserve of $10,000——

Mr. White: 10 per cent would be a hundred thousand.

The Witness: A hundred thousand. Let's raise that hundred thousand to a hundred and five thousand for the purpose of——

The Court: You raise that to a hundred and five thousand?

The Witness: He has built up an equity in his reserve and finally got five thousand above his 10 per cent——

Q. (By Mr. Hankins): 10 per cent is——

A. He has 5 per cent. Ordinarily that would be available to him from his reserve account, except for the fact that—let's say we have $6,000 worth of delinquent [26] accounts and another $3,000

(Testimony of Russell H. Simpson.)

worth of repossessions, that would be $8,000. That would reduce his reserve down to $97,000 and he wouldn't be able to withdraw any of his reserve.

The Court: I am a little confused here. I followed you very well to this point. As I understand it, in the example, $15,764.32 is a sum to be credit balance in the dealer's reserve?

The Witness: Right.

The Court: Now, am I correct in my assumption that if that figure at a particular date—what is it, at the end of the year or periodic?

The Witness: Any date.

The Court: On any date the dealer wants to withdraw—draw down whatever he made, he is permitted to draw down the excess of that amount represented in this case by the fifteen-thousand-odd dollars over 10 per cent of the bank reserve, that is, 10 per cent of the outstanding contract balances; is that right?

The Witness: That is correct up to that point.

The Court: All right. Now, can you explain further now about this other matter that I speak of? Let me also ask you this: When you said that if there are any accounts in default, did I understand you to say when there are accounts in default the full amount of that particular account is [27] subtracted from that $15,000?

The Witness: Correct.

The Court: And what else might ever be subtracted from the $15,000 reserve?

The Witness: Any unpaid repossessions. Re-

(Testimony of Russell H. Simpson.)

possessions that the bank has returned to the dealer for payment which has not yet been received by the bank.

The Court: Who repossesses?

The Witness: The bank.

The Court: The bank repossesses?

The Witness: Yes.

The Court: Does the bank sell those cars, resell——

The Witness: No, we return them to the dealer under his recourse agreement with the bank.

The Court: That means you are going to—the bank will collect nothing more on the original contract with the purchaser?

The Witness: That's right.

The Court: And whatever you have advanced, you will expect to get back from the dealer; is that right?

The Witness: Correct.

The Court: And until that is paid to you by the dealer, do you subtract that from that credit balance, the dealer's credit balance of $15,000?

The Witness: Right. [28]

The Court: Isn't that easier, an easier explanation than this matter of adding five thousand dollars over here, or is that something different again?

The Witness: No, sir, that is just an example.

The Court: And that is the same point you are trying to make, that I brought out?

The Witness: Yes, sir.

Q. (By Mr. Hankins): Well, then, assuming

(Testimony of Russell H. Simpson.)

that the outstanding balances at any one date was $100,000 on these contracts assigned by the dealer to the bank, and that all of its 35-day accounts, overcharges for repossessions, and so forth, amounted to $3,000 on that particular date, then you would take 10 per cent of this figure right here, or $10,000 and you would add $3,000 to that figure and come up with $13,000 which you would compare then with the $15,000 in the reserve, and if those were the conditions, then would the dealer be allowed to draw down the balance in excess of the $13,000?

A. Yes, he would be allowed to draw down anything in excess of 10 per cent of his contingent liability.

Q. This is assuming that his outstanding contracts, contingent liability is $100,000, this is 10 per cent you stated that you would add all accounts on which there was one payment past due?

A. We would deduct those accounts on which there was [29] more than one payment past due from his reserve.

Q. That is what I am doing over here——

A. And pay him the excess over 10 per cent on that figure.

Q. Then, this figure then is never subject to his immediate withdrawal?

The Court: What figure is that?

Mr. Hankins: The $67.25 when it goes into his reserve account.

The Witness: No.

(Testimony of Russell H. Simpson.)

Q. (By Mr. Hankins): But the total of all figures that go into his reserve account, you make subsequent computations of, taking 10 per cent of outstanding balances, add to that all the contract accounts over 35 days past due, and if he has any excess, he has a right to receive that; is that correct? A. Right.

The Court: Now, there is one point I would like cleared up on the record.

You say 10 per cent of the total of contract balances?

The Witness: Yes.

The Court: For example, in the example stipulation, it would be 10 per cent of line 9 in the example, namely, $1416.05. [30]

Now, in the example that has been referred to by counsel of a million dollars outstanding of the contract balances, I understand you take 10 per cent of that, namely, $100,000 and what would you call that figure, the $100,000?

The Witness: A reserve account.

The Court: That is a reserve account that the bank sets up. Now, do you provide—do you proceed further in the computation and take 10 per cent of that?

The Witness: May I explain it this way: That portion, $67.25 up in the dealer's reserve account gradually builds to a 10 per cent reserve, and that would be 10 per cent of the contingent liability sum total of all the contract balances of which have been assigned to us.

(Testimony of Russell H. Simpson.)

The Court: Off the record for just a moment.

(Discussion off the record.)

The Court: On the record.

Q. (By Mr. Hankins): At the time these contracts are assigned to you, do you pick up the total of the unpaid or the total of the contract balance on your books as accounts receivable at that time?

A. Yes, we do.

Q. Then, what is your offsetting interest to your contracts receivable, assuming that the contract was assigned to you and contained the identical figures which we have in [31] the stipulation?

A. On the debit side of the ledger contracts receivable would be a figure of $1233 even. There would be a cashier's check for $40 sent to the Department of Motor Vehicles.

Q. Cash, $40,——

A. There would be credited to the unearned discount $70.90—$75.90, there would be a credit to the dealer's reserve account of $67.25.

Now, we have an error in where it says "accounts receivable," that would be "cash to the dealer," $1233.

The Court: That is debit on the books——

The Witness: Those amounts would make up the contract balance which would be—you would call it accounts receivable.

Q. (By Mr. Hankins): Then you would have accounts receivable—— A. $1416.

The Court: $1416.05.

Q. (By Mr. Hankins): Then, upon assignment

(Testimony of Russell H. Simpson.)

of this contract to the bank, you would pick up on the bank records contracts receivable of $1416.05 —15 cents, and your offsetting credits, you would pay the dealer $1233 in cash and you pay the Department of Motor Vehicles $40, and then, in your unearned discount [32] you would place $75.90, and into the dealer's reserve account $67.25?

A. That's correct.

The Court: When does the five dollars go into the earned——

The Witness: That is only when we buy the contract.

The Court: In other words, that figure $75.90 represents both earned and unearned discount?

The Witness: Yes.

The Court: Very well.

Mr. White: May I interrupt? I don't believe the debits and credits are equal. I see, I am sorry.

Q. (By Mr. Hankins): Now, Mr. Simpson, when you make your computation at the bank to see whether the dealer is entitled to any money, do you look at the total of this contract balance which is represented by our typical example of $1416.15 in order to arrive at a total amount on which you would compute your 10 per cent for determining how much might be available out of the dealer's finance reserve to the dealer? A. Yes, we do.

Q. Well, then, assuming that you added all of the contract balance which had been assigned to you by the Art Morgan Motor Company and those balances equaled one million [33] dollars and you

(Testimony of Russell H. Simpson.)

totaled up all of the accounts that were past for more than thirty-five days and the total of those such accounts totaled $3,000 and the balance in the dealer's reserve account at that particular instance was $15,764.32, would the dealer be entitled to receive any money from you? A. No.

Q. Then, in the way you computed this, you would have taken your million dollars of contracts outstanding, and take 10 per cent of that which would be $100,000 and compare that with the $15,-764.32, and the dealer's reserve, less than $3,000 of over thirty-five-day accounts, leaving $12,000 and since the $12,000 is less than the hundred thousand, he is not entitled to any money?

A. That's correct.

Q. Now assuming that these contract balances that have been assigned to the dealer were to equal $100,000, the dealer's finance reserve is still $15,-764.32, and the over thirty-five-day delinquent account is $3,000, then would he be entitled to receive any money?

A. Entitled to receive $2764.

Q. The way you compute that, then, is to take your $100,000 of contract balances, take 10 per cent of that, $10,000, and compare that with the $15,000 less $3,000 which leaves a balance of $12,000, and since that $2,764.32 is in excess of 10 per cent of the contract balance, he is entitled [34] to draw down the $2,764.32? A. That's right.

The Court: As I understand it, that is true at

(Testimony of Russell H. Simpson.)

any particular time that the dealer cares to pull it down?

The Witness: That's right.

The Court: If he does have a favorable balance?

The Witness: Right.

The Court: As a matter of fact, how do they do it? Every month?

The Witness: It varies with various companies, one large finance company every month, one large bank that I know of every month, and in our bank we do it on their request.

The Court: Yes.

Q. (By Mr. Hankins): Mr. Simpson, you mentioned in your testimony that there was no money represented by the credits to the dealer's finance reserve, for example — or $67.25, that was only a bookkeeping entry on your books. What, if anything, must happen before the dealer would ever be entitled to receive any of this money in his dealer's finance reserve?

A. There would have to be some collected balances reduced, money received.

Q. In other words, the contract balance must be reduced? [35] A. That's right.

Q. Before, under your contract with him the sum of these would never exceed the 10 per cent limitation which you have with the Art Morgan Motor Company? A. That's right.

The Court: That is the sum of all the specific dealer's share items that are put in reserve account for the dealer on the individual account. That is the trouble, when you are looking at a blackboard,

(Testimony of Russell H. Simpson.)

you say "this," and it is hard to determine from the record what you mean.

Q. (By Mr. Hankins): In essence, then, Mr. Simpson, this is merely a first allocation of $67.25, that is merely a bookkeeping record in the bank to determine what ultimately under your contract may be paid to the dealer; is that right?

A. That is correct.

Q. Mr. Simpson, assuming from our typical example that you have set forth in Paragraph 10 of the stipulation of fact that the blue book value of that car at the time it was assigned, the contract was assigned to you, was $1,000, would you in that case give Mr. Morgan $1233?

A. No, we would not.

Q. What would you do at that time with the contract?

A. We would probably put in a separate withhold account called "Art Morgan Motor Company Withhold Account," [36] the excess there of $233 over the blue book value of a thousand.

The Court: Now, the purchaser would still be obligated to pay to the bank the $1233, plus the other charges?

The Witness: That's right.

The Court: But since the car had a value of only a thousand, you would not pay to the dealer the full amount?

The Witness: That's right.

The Court: But only the amount that you figured the car was worth, but then I assume if it is paid out, you would pay that over; is that the idea?

(Testimony of Russell H. Simpson.)

The Witness: That is correct. As the account was paid down within the limit, we would refund some money out of the withhold account to the dealer.

Q. (By Mr. Hankins): Then, in essence, this is a security account for the bank on that account?

A. You could call it that, yes.

Q. And if these were the facts, the contract under unpaid cash balance of $1233, the value of the car $1,000, you wouldn't get around it another way by saying "we want all of this time price differential, plus some of the unpaid balance"; would you? [37]

Mr. White: Your Honor, I have been allowing considerable leading, but at this point counsel is putting words right into the mouth of the witness.

The Court: Mr. Hankins, would you rephrase your question?

Q. (By Mr. Hankins): Mr. Simpson, assume these are the facts, that the unpaid balance, unpaid cash balance of $1233, the value is $1,000. Is there any other way you would handle this contract besides taking the $233 and putting it into the dealer's withhold account?

A. No, not unless we rejected the contract entirely.

Q. Mr. Simpson, do you know the purpose of the bank in setting up this dealer's finance reserve account credits which they have in the so-called dealer's reserve?

A. Yes, I know the reason.

Q. What is their purpose in doing that?

(Testimony of Russell H. Simpson.)

A. To further secure the bank against the dealer's guarantee to the contract, secure the dealer, the dealer guarantees a given account — say a million dollars in paper, in such case we want further reserve. The dealer is going to guarantee the contracts, he is going to charge a rate where he can get that contract, the bank sets a rate of 5 per cent for the dealer and the dealer may charge 8 per cent, the difference going into the reserve account and we keep [38] control of the reserve account.

Mr. White: Would the reporter read that back, please?

(Record read.)

Q. (By Mr. Hankins): Does the dealer guarantee all the paper assigned to you? A. Yes.

Q. Then, in part for that guarantee, then, of those accounts you make this type of arrangement with him where you will let him share in some of the dealer's finance reserve——

Mr. White: Your Honor, I object to the phrase "sharing in the dealer's finance reserve." I wish counsel would ask the witness a question and let him give a yes or no answer.

The Court: Mr. Hankins, I suppose that is probably a conclusion.

Q. (By Mr. Hankins): Mr. Simpson, do you know whether or not the purpose in setting up this dealer's reserve account for the dealer is for the purpose of getting the dealer to guarantee the paper to the bank? A. Yes, I know.

Q. Would you state whether it is or not for that [39] purpose, the purpose of securing the

(Testimony of Russell H. Simpson.)

guarantee by the bank of the paper which is assigned by the dealer to the bank?

A. I would say it is one of the reasons.

The Court: At the same time, the bank did have the security of the car itself, did it?

The Witness: That's right.

Q. (By Mr. Hankins): When these accounts were assigned by the dealer to you or to the bank, did the bank check the credit references of the purchaser? A. Yes.

Q. Did the bank ever reject any sales assignment of contracts to the bank?

A. Yes, we have.

Mr. Hankins: You may cross examine.

The Court: It might be well to take a short recess before cross examination.

We will recess for lunch for one hour.

(Thereupon a recess was taken at 12:30 p.m. to reconvene at 1:30 p.m. of the same day.)

After Recess, 1:30 p.m.

RUSSELL H. SIMPSON

resumed the stand, pursuant to recess, and testified further as follows:

Cross Examination

Q. (By Mr. White): Mr. Simpson, in your direct examination, you testified that the procedure used in the case of the Art Morgan Motor Company was the same as that used for all automobile dealers.

(Testimony of Russell H. Simpson.)

With that thought in mind, was the conditional sales contract the same form of contract?

A. Yes.

Q. And the contract which is in evidence as Exhibit 2-B, was that the same form of contract—I will show you Exhibit 2-B.

A. Standard form, standard dealer agreement that we use.

Q. In discounting conditional sales contracts or purchasing them from these other dealers, do you know if any time the sum which was credited to that dealer's reserve account was based on the unpaid balance shown on the sales contract, the conditional sales contract?

A. The best I can answer that is: We would figure the charge, the bank charge on the contract, on the contract [41] balance.

Q. By "the bank charge," you mean the discount? A. That's right.

Q. Now referring to the credit which is a sum entered into the reserve account of the particular dealer, do you know if in the case of some dealers the bank would credit a sum which is based on the unpaid balance on the particular conditional sales contract being purchased from that dealer?

Item 7, if you care to look at it, is labeled "Unpaid Balance." It is Exhibit 1-A I am pointing to—I take that back, I should have said Item 6 is labeled "Unpaid Balance."

Now the question is: Do you know if in the case of other dealers the bank sometimes bases the

(Testimony of Russell H. Simpson.)

amount of credit to the reserve account upon the unpaid balance?

A. In our bank we do not figure on the unpaid balance. We figure on the contract balance.

Q. You figure what on the contract balance?

A. The bank discount.

Q. I am not referring to discount, I am referring to the sum which is credited to the reserve account.

The Court: To the dealer's——

Q. (By Mr. White): The dealer's reserve account? [42]

A. The unpaid balance wouldn't have any relation to the dealer's reserve.

Q. Can you state if you know at any time this bank, the Farmers & Merchants National Bank of Long Beach, based on that credit, that unpaid balance—the term, if I could rephrase it — used that unpaid balance to determine the amount which they would credit to the reserve account? A. No.

Q. Is that your answer that you do not know?

A. I would say we do not use the unpaid balance to determine the amount of reserve to go into the dealer's reserve account.

Q. Can you state to your knowledge that that has never been done in the Farmers & Merchants Bank?

A. To my knowledge, it has not been done.

Q. But you cannot state it has not been done?

A. I can state it would not be done as a matter of policy to the bank.

(Testimony of Russell H. Simpson.)

Q. The next question is: What would be the method of determining the amount to be credited to the dealer's reserve account?

A. We compute the bank discount—we subtract that from the time price differential, as referred to in Exhibit A, and the balance that is left would be credited to the dealer's reserve account. [43]

Q. Are there any other methods of determining the amount to be credited to the reserve account?

A. Not in our bank.

Q. In the instant case, in the example we have used on the blackboard, you see a sum of $1,233 which was the sum paid by the bank to the dealer. What if the bank decided that it considered that too much to be paid to the bank, even after its normal discount and wished to put a larger sum in the reserve?

A. If there were too much money to be paid to the dealer from the contract, it would not be put in the dealer's reserve, it would be put into the dealer's withhold account.

Q. What if there is no time price differential, Mr. Simpson, then what do you credit to the dealer's reserve?

A. We wouldn't have any credit to the dealer's——

Q. How is that?

A. We wouldn't have any credit to the dealer's reserve if there were no time price differential.

Q. What would you use as your security on that contract?

(Testimony of Russell H. Simpson.)

A. We probably wouldn't buy the contract.

Q. Supposing you did buy it, there is nothing holding you from buying it if it looks like a good contract at a fair price and you wish to purchase that contract, then what would you credit the dealer's reserve? [44]

A. If there is no time price differential, there is no discount, we wouldn't buy the contract.

Q. Why wouldn't you?

A. At a discount?

Q. Yes. A. Simply isn't done.

Q. You may not do that as a matter of course, Mr. Simpson, but in your knowledge of banking, why is it impossible to buy a note or a conditional sales contract which doesn't have the finance charge on it?

A. I don't know of any instance where that has been done.

Q. Can you think of any reason, any principle of banking, which would make that impossible?

Mr. Hankins: I object to that, your Honor. These facts he is trying to bring out are not in evidence, in the first place, and we have an example here in evidence that we have been using for a typical example, and the man has stated that they don't do it there, and he is only asking for his opinion or what may happen in other banking circles, and I don't think it is properly put, it is not a proper question.

Mr. White: I think in a few moments we will

(Testimony of Russell H. Simpson.)

get to the propriety of the question. If you wish, I will make my point immediately.

The Court: If you think it is material and can link [45] it up, go ahead. It does seem hypothetical and beyond the practice here, but go ahead.

Q. (By Mr. White): Is there any principle of banking which makes it impossible to purchase a conditional sales contract without a price differential?

A. I don't know of any exception to our present procedure.

Q. If the bank purchases a conditional sales contract without a time price differential at its usual discount rate, why wouldn't it earn its usual interest or usual type of income?

A. I'm awfully sorry, but would you give me that again?

Q. If a bank were to purchase a conditional sales contract that does not have a time price differential, purchase the contract at its usual discount rate, four and a half per cent a hundred of the contract balance, assuming the contract is paid in full in the normal course, won't the bank then earn its discount or interest just as if there had been a time price differential?

A. I can only say the bank would never purchase a conditional sales contract on that basis.

Q. I will ask you another question. The sum of $67.25 was credited to the dealer's reserve. Now, I have allowed Mr. Hankins, counsel for the Petitioner, to [46] say that this is a part of the time

(Testimony of Russell H. Simpson.)

price differential, and you say it is part of the time price differential. Now, we have in this case a contract balance which is more than $67.25, it is $1,416.15. Now, I want you to tell the Court by what earmark on this sum you can say, unqualifiedly, that it comes from the time price differential and not from the contract balance. What is the earmark? What is the identification of that sum which assures you it came from the time price differential and not from the contract balance?

A. We would figure the bank charges and from the contract balance, after we arrive at that balance, we would take the $143.15, which is the time price differential, and that identifies it, earmarks it.

Q. The bank discount in that case was $75.90?

A. Correct.

Q. Assuming the time price differential was $75.90, then what would you credit to the dealer's reserve account?

A. There would be no credit.

Q. Would you then pass up the contract? Would you necessarily pass up that contract?

A. We may, yes.

Q. If you do not, what would you credit to the dealer's reserve?

A. If we passed the contract up, there would be no [47] purchase, there would be no interest.

Q. What?

A. We probably wouldn't buy the contract.

Q. That is a probability. Another probability is that you would buy it. Assuming you bought this

(Testimony of Russell H. Simpson.)

contract, your discount is $75.90, what would you credit to the dealer's reserve?

Mr. Hankins: I still object to that, your Honor. He is assuming facts not in evidence here, that they did buy a contract of $75.90 and for the dealer's finance reserve the time price differential was shown on there. We have no facts in evidence that there was a contract of that nature.

Mr. White: Your Honor, if the only issue is this one contract the petitioner would have a point, but we are dealing with an example. If the petitioner can use it as an example, how can this witness unqualifiedly tell the Court that that sum of $67.25 comes from the time price differential and could not possibly come from the contract balance?

The Court: I think it is proper to test this out and with the understanding, of course, this witness has said they do not buy contracts under those circumstances.

Q. (By Mr. White): Now, assuming you did buy a contract which had a time price differential and you took your normal discount which might be a dollar less but approximately $75.90, in [48] that case what would you credit to the dealer's reserve?

A. Well, first of all, if we bought a contract under such conditions, we would charge an additional rate for the contract.

Q. You mean an additional discount?

A. That's right.

Q. You——

A. We would not be able to ask the dealer to

(Testimony of Russell H. Simpson.)
sign the contract "with recourse," therefore, it would become a direct bank deal, there would be no liability on the part of the dealer in the occasion of repossession or default.

Q. You could still buy this contract with recourse on the part of the dealer, the dealer is fully liable under guarantee as under any—now, we are postulating a case where the bank purchasing this contract in the usual way with recourse charges, its usual discount of approximately $75.90, I ask you, under those circumstances what would be credited to the dealer's reserve?

A. We wouldn't buy a contract on that basis.

Q. I think you see the point of my question, Mr. Simpson. I am trying to illustrate the Government's position that you can't point to $67.25 and say "it has this particular earmark, it is this color or this shape, therefore, it came from the time price differential." The Government says "How do you know it didn't come from the contract balance which is [49] certainly large enough to include it?

Mr. Hankins: I object to that as arguing with the witness, your Honor. If counsel wants to testify——

Mr. White: I will ask that my tone of voice be excused, but I think the witness is avoiding my question and that is the reason I am a little bit anxious to explain the purpose of this. We can forever postulate the example and he can forever say they wouldn't buy it, but we are assuming they do buy it. It doesn't strain the imagination at all. I asked "If

(Testimony of Russell H. Simpson.)

that is what happened, what would you credit to the dealer's reserve?"

The Court: The witness is in a difficult position there to state what would be done if it has never been done. I don't know that he makes up policies of the bank, but I see the point you are driving at and I would like for the witness to say under the theory, as he understands the bank's approach on this, would you under those circumstances put anything in the dealer's share; if such a thing were done, would you with your knowledge of the system which you employ?

The Witness: Your Honor, I just have never heard of a case of that kind, and I would have to pass. I wouldn't know of a way that it could be done, unless the loan was submitted to us in a different form on a—say, a general pledge, or something of that kind whereby a number of contracts at the rate, but not on an individual sales contract for [50] an individual dealer.

Q. (By Mr. White): Let me ask you this question, Mr. Simpson: How do you determine the adequacy of the sum that you are crediting to the dealer's reserve?

A. Our experience with dealer paper, as a whole, is with the dealer himself.

Q. So it could be a case identical with this one where you would credit more to the dealer's reserve?

A. No, we can't credit more to the dealer's reserve unless he gets additional charges.

(Testimony of Russell H. Simpson.)

Q. You said that on direct examination. I didn't understand that and perhaps the Court didn't. Why couldn't you credit more to the dealer's reserve?

A. We could if the dealer charged more or charged a bigger rate when he sold the automobile.

Q. When you say "charged rate," you mean took a high discount? A. Yes.

Q. Assuming you didn't, is there any reason you couldn't charge more credit to the reserve than $67.25?

A. In this particular case, we couldn't.

Q. Why not?

A. Because the dealer's rate is set for all contracts.

Q. Set by whom? [51]

A. Farmers & Merchants Bank.

Q. The Farmers & Merchants can alter it, then?

A. Well, dealer rates are set because of competitive reasons within the trade.

Q. If in the opinion of the Farmers & Merchants National Bank, the condition permits to credit larger sums to the dealer's reserve, what is to keep it from doing so, Mr. Simpson?

A. We would have to give our dealers a notice of 15 or 30 days that we were going to raise our rates to them.

Q. If Mr. Morgan came to you today and said, "Would you purchase this conditional sales contract?", couldn't you tell him then and there, "first of all, Mr. Morgan, we want four and a half per

(Testimony of Russell H. Simpson.)

cent as a discount, and in addition $70 credited to the reserve account?

A. I suppose it would be possible to say that to Mr. Morgan. I don't believe we ever have, but we might take a withhold and put it in his withhold account.

Q. Assuming the dealer's reserve balance, the credit balance, is in the deplorable condition of very low, and he comes to you with a contract for an automobile and maybe the unpaid balance is approximately $10,000, must you at this point again restrict yourself to the time price differential or could you tell him, "This is an extra-risky contract and we want more put in the reserve"? [52]

A. No.

Q. Why not?

A. Either take a withhold on the account, or we would reject the contract.

Q. Now, this withhold account, is that a credit?

A. That is a credit.

Q. You credit that account. Is it shown as a liability?

A. On Mr. Morgan's books it would be an asset, to the bank it would be a liability.

Q. It is shown as a liability?

A. In the bank.

Q. What is the purpose of that account?

A. That is just for the security as far as the bank is concerned. In other words, we are going to advance the market price of an automobile or a contract calls for a balance in excess of the market

(Testimony of Russell H. Simpson.)

price and we take the difference and put it into the withhold account.

Q. That account is for security purposes?

A. That account is to secure that particular contract.

Q. The reserve account, what is the purpose of that account?

A. To induce the dealer to discount contracts with us, sir.

Q. Is it a security account? [53]

A. A security as far as the dealer is concerned.

Q. And it is to secure the bank?

A. So far as the bank is concerned, it is a method of getting business.

Q. Isn't it to secure the bank, to assure the bank that the dealer will meet all liabilities to the bank?

A. It also acts in that capacity.

Q. How is that?

A. It also acts in that capacity.

Q. Is that a credit account—is that a credit, Mr. Simpson? A. Credit.

Q. Is that shown as a liability? A. Yes.

Q. Now, you tell the Court, how does that account differ from the so-called withhold account?

A. Very simple. On the withholding account, each individual account is refundable at the time it is paid down to a balance that is within the bank requirements.

On the reserve account, the reserve account as related to the contingent liability of all contracts put together——

(Testimony of Russell H. Simpson.)

Q. So, as I understand your testimony, the only difference between the two accounts is that one can be tied in at any particular moment to a contract that would be your [54] withholding account, and your reserve account cannot be tied in with any particular contract, depends on the total unpaid balance? A. Correct.

The Court: On the withholding account, in the example where a car was taken in at a value of $1,000 and the selling price was $1233, and there was a withholding account of $233, you would pay that individual amount to the dealer whenever conditions warranted it in the bank's estimate, is that right? And that would not have any effect on your calculations of how much at any given time the dealer could claim from the dealer's reserve account, is that correct?

The Witness: That is correct, sir.

Q. (By Mr. White): Would you refer to Paragraph 10, Mr. Simpson, of the stipulation. Paragraph 10, I'll run down this particular contract to make sure we all understand what occurs.

The contract balance, which is Item 9, is approximately $1400?

A. The dealer comes to the bank and says, "Will you purchase this?"

The bank says, "Yes" or assignment is made, the bank purchases that contract for $14,000, less its discount.

The Court: $1400. [55]

Q. (By Mr. White): The contract balance is

(Testimony of Russell H. Simpson.)

$1400, approximately $1400, to be exact, $1,416.15.

Now, when the dealer comes in and asks if you will handle this contract, Mr. Simpson, you would purchase it for that sum, less the bank's normal discount? A. No.

Q. What sum would you purchase it for?

A. We purchased for Item 7, the unpaid balance.

Q. Let's run through on that. You would pay $1,273 in cash to the dealer?

A. Yes. I must qualify that one item, $40 item. If we cleared the title, we had to send that $40 to the Department of Motor Vehicles, then we would pay $100—$1233 to the dealer and send $40 to the Department of Motor Vehicles, and we would have an unpaid balance of $1273.

Q. Assume the dealer cleared the title and paid the $40 to the Motor Vehicle Department, you would pay the dealer $1,273? A. Right.

Q. All right. That would go to him in cash, and then you would withhold this dealer's reserve of $67.25. I am going to make some mathematical computations.

The contract balance is $1416.15. If we subtract from that $75.90, which is the bank discount, using the [56] example you gave on direct examination, that would leave a balance of $1,340.25. Then if we subtract from that $1,340.25 the amount which you credited to the dealer's reserve, the difference would be $1,273.

Now, how can you tell the Court that the only

(Testimony of Russell H. Simpson.)

way to compute this is by going to the unpaid balance and say "We paid him that sum"? What is the gross error by the respondent's theory to say that which you paid him is a contract balance, less your discount and less sum credited to the dealer's reserve? I'll go through it again——

The Court: Just a moment. The witness said he didn't see there was any gross error there, is that right?

The Witness: I don't — I may have missed a point there. I see no gross error of any kind.

Q. (By Mr. White): I will take a moment to explain again. I don't want to argue with you. The Government contends that the bank doesn't buy unpaid balance shown by time price differential, the bank buys a contract balance——

Mr. Hankins: I object to this——

The Court: He is explaining. I think he is telling the witness what the contention is for the purpose of clarification only.

Mr. White: I am giving the Government's position, and he can show the Court where the Government is wrong. [57]

The Court: I take it there is no argument with the witness at all, you are doing this for the purpose of explaining?

Mr. White: That is absolutely correct.

The Court: Now, what is your question again?

Mr. White: The question is: How can this witness assure the Court that the sum which is paid to

(Testimony of Russell H. Simpson.)
the dealer in cash is not the contract balance less the discount and less the credit to the reserve?

The Witness: Now, the last part of that again, please?

Q. (By Mr. White): I say, how can you assure this Court that the sum paid to the dealer in cash is not the contract balance after you have subtracted from your discount and your credit to the reserve account?

A. Well, the two are the same, the way you figure it out, but actually in practice they are not, because one cash is paid out — I mean the cashier's check is a bookkeeping entry, there is no money— no money has been received yet on this contract, it can't be anything else but a book entry. It is merely a distribution of anticipated receipts which is part of this contract.

Q. Isn't it correct, Mr. Simpson, that the sum you are distributing is the sum in No. 9, the contract balance? [58] You take that sum and say "We will distribute it in this manner, part will go in cash to the dealer and part will be retained by us as our own organization discount, and part will be placed in the dealer's reserve account"?

A. That's right, no argument about that.

Q. So, I ask—my question, again, is about the sum which is credited to the dealer's reserve account. By what test, by what determination can we say that the $67.25 necessarily came from the time price differential and did not come from the contract balance?

(Testimony of Russell H. Simpson.)

A. One is cash and the other is a book entry. One entry is cash balance and the—how much cash is being expended, and Item 8 is a book entry, because no cash has been received and Item 9 is a total of the two.

The Court: May I ask at this point, to clarify my own thinking, isn't it true that at this particular time, when you take the contract, not only has the purchaser not paid any of the time price differential, but he hasn't paid any of the principal amount of the purchase price of the car?

The Witness: That's right.

The Court: So to that extent they are similar, namely, the bank hasn't yet gotten any money from the purchaser, but it does disburse to the dealer a certain amount of cash, namely,—How much here in this case?

The Witness: Well, your Honor, down to line 7 [59] cash has been disbursed by the bank.

The Court: I see, the twelve hundred and seventy-three?

The Witness: That is correct.

The Court: Yes. You have disbursed that to the dealer?

The Witness: To the dealer or to the Department of Motor Vehicles.

The Court: Or in some cases for the Motor Vehicle tax, the $40 in some cases?

The Witness: That is correct.

The Court: Whereas, on the time price differential, which is something that the purchaser of the

(Testimony of Russell H. Simpson.)

car is also liable to pay, that is not disbursed immediately to the dealer, but a portion is set up, some portion is set up in a reserve for the dealer, as you described in your direct testimony, and part of it is set up on your own books as what you—what did you call that?

The Witness: Unearned discount.

The Court: Is that called an unearned discount also? There is additional discount, is there not, that you——

The Witness: There is. In other words, the rate plus five dollars. The five dollars is earned and that goes into earned discount, but the balance goes into unearned discount and that is never taken out until the entire contract [60] has been made, and is transferred from unearned to earned discount, and the bank has earned it.

The Court: I am a little confused again. Perhaps the record shows the correct picture, but how about the $75—I see, that is divided, that figure of $143.15 you say is divided into $75.90 which includes both earned and unearned discount for the bank and $67.25 which is the dealer's share put into the dealer's reserve to be paid under circumstances you have described before.

The Witness: Right.

The Court: Now I have this question: How do you arrive at the $75.90 again as being the bank's share of that?

The Witness: By the rate we charge the dealer.

The Court: Is that a specific rate?

(Testimony of Russell H. Simpson.)

The Witness: I believe at this time, and I am going to have to ask Mr. Morgan to develop that, I believe at that particular time our rate to Art Morgan Motor Company was 4 per cent on the gross balance of the contract.

The Court: On gross balance of contract, which would be what figure here?

The Witness: Line 9.

The Court: Line 9——

The Witness: 4 per cent, plus $5 would equal $75.90. [61]

The Court: I see. You would figure 4 per cent of $1416.15?

The Witness: May I add this, your Honor, it would be 4 per cent per annum, this contract, I believe, is a fifteen-month contract.

The Court: I understand that. So it would be at the rate, though——

The Witness: 4 per cent.

The Court: $1416.15, and then to that you add $5?

The Witness: That's right.

The Court: The other question I had was this: Is that rate set forth in any contract with this partnership?

The Witness: Subject to change, your Honor; it may be set forth in a contract and it may be changed later.

The Court: I see. Off the record for a moment.

(Discussion off the record.)

The Court: On the record.

(Testimony of Russell H. Simpson.)

Then, as I understand it, the rate of discount which the parties may have agreed upon is applied to Item 9, namely, "Contract balance," which determines the amount of discount which the bank is to have, and then that figure is subtracted from the figure which has been designated here as time price differential, $143.15, in order to determine how much goes into the dealer's share reserve? [62]

The Witness: Correct.

The Court: And if the dealer should choose to charge a greater rate to the purchaser of the automobile, greater than the $143.15, as set forth here in this example, then any excess he charged would then go into the bank's records as a credit to the reserve for the dealer's share?

The Witness: That's right.

Q. (By Mr. White): Continuing on that line, Mr. Simpson, what is troubling me, I mention this again by way of explanation so you understand my question: Is it that the bank wants this credit for security purposes, it wants to be assured [63] in some way that the dealer will meet his obligation?

Yet, the second point we seem to make that the amount be credited is just left to the dealer, depending on what he decided to charge as a time price differential because it's always going to be the leftover after you reduce that sum by the bank's discount, which in this case is $75.90. If you felt as though—it seems to me that in that case you might have only a few dollars left over to go into this reserve and the bank would not be fulfilling its

(Testimony of Russell H. Simpson.)

obligation—objective of seeing that each contract bears—has some reserve to assure its dealer's liability.

So, with that thought in mind, I ask you this question: Assuming the dealer for some reason did not charge [63] $143.15 as time price differential, but charged a lesser sum; in that circumstance—correct me if I am wrong—the bank will still take the usual discount rate of approximately $75.90; is that correct?

A. Go ahead with the rest of it.

Q. All right. Is the bank then with hands tied, is that it? It cannot insist on $67.25 going into the reserve account?

A. Is the bank's hands tied in insisting they cannot go into the $67.25 credited to the reserve account? Your question is a hard one to answer, because I have never known a dealer to guarantee a contract unless he got paid something in his dealer reserve account and, as I think I mentioned before, if we bought such a contract it would have to be on a direct bank deal, it couldn't be guaranteed by the dealer, it would be the bank's deal with the purchaser and then we would consider a direct bank loan and we would not charge four and a half per cent, we would charge six per cent.

Q. This time price differential, Mr. Simpson, and this credit to the reserve has been referred to as sharing in the time price differential and at other times the credit has been referred to as a security. What if at the time this contract was as-

(Testimony of Russell H. Simpson.)

signed you had a large credit balance, far in excess of 10 per cent of the unpaid contract balance, would you insist on a credit of $67.25 to the reserve? [64] A. Yes.

Q. Why would you do that?

A. So the dealer continues to build up and continues an equity in his reserve.

Q. We are assuming a reserve which at that time was in excess of fifteen months, you would then pay a credit of $67.25 and if at that moment the dealer insisted on you paying him $67.25, you would be obligated to pay him that cash, $67.25, am I not correct?

A. I couldn't visualize such a situation, it isn't the usual thing. I have never heard of him wanting a particular reserve in that exact amount.

Q. Assuming he asks for $100?

A. Somebody asked for two thousand or twenty-five hundred, fine; but we wouldn't want the dealer continuing to put money in his reserve.

Q. In effect, it—isn't this situation I have just outlined one in which there is no credit to the dealer's reserve——

A. You see, it wouldn't be that $67.25 he would be getting, it would be the $67.25, that equity built up by contracts that had earned the charges paid off, and so forth.

Q. Now that gets us back again to how do you identify the $67.25 and say that it's this one and not that one?

A. You don't identify any particular one and

(Testimony of Russell H. Simpson.)

you [65] don't pay any particular one, you pay it on equities in the reserve.

Q. Would the bank insist on this credit in the reserve, Mr. Simpson, if the partnership deposited with the bank collateral or cash which is always 10 per cent in excess of unpaid balance?

A. There would have to be some reserve for this reason: that on thirty-month contracts and with a $450 discount and, say, $150 is going to the dealer's reserve and $300 going to the bank, and in one month if that customer came in to pay that account off, we would have to have a reserve to charge the refund on our charges.

Q. Would it be possible to charge to this deposit of cash which he left with you? A. No.

Q. Why not?

A. There would be no accounting for it.

Q. Why couldn't you make a debit to that accounts payable instead of a debit to the reserve account?

A. He made a cash deposit to a specific reserve.

Q. He deposited with you a sum far in excess of the 10 per cent of the unpaid balance at this particular time, and far in excess of what it has ever been in the last five years, and he gave it to the bank and says, "This is security for my obligation, my obligation as guarantor of conditional [66] sales contracts, under those circumstances would it be necessary to credit a reserve when a contract is assigned to you?

Mr. Hankins: Your Honor, he is bringing in a

(Testimony of Russell H. Simpson.)

lot of conjectures in this thing. Each case depends on its own facts. In that particular case, we are surmising what would happen in any unusual situation and those unusual situations didn't happen here, he never showed that any happened here, and I object to this type of cross examination of the witness. If he sticks to the facts in this particular case, fine, but we can surmise almost any kind of possible situation.

Mr. White: Your Honor, there is a purpose to this. The witness has used such terminology as this credit being a sharing in the time price differential.

The Government's position is that is merely a security, a credit made for security purposes. There are no shares.

Now, I am bringing this up to illustrate that by showing if the bank is adequately secured by a deposit of cash made by the partnership which is far in excess of the 10 per cent of the unpaid balance, in that circumstance the bank would not credit a dealer's reserve.

Now, I am asking Mr. Simpson if that is true.

The Court: Well, it does seem we are getting pretty [67] far beyond the actual facts of the case. As I understand it, the dealer does guarantee the bank on these contracts.

The Witness: That is correct.

Q. (By Mr. White): Does the dealer ever put up any money as security for its obligation to the bank?

(Testimony of Russell H. Simpson.)

A. Only one instance that I know of in the twelve years that I have been with this particular bank has any dealer put in as much as $1,000 in his reserve account, and that was to start him off in a new venture, and that was a voluntary action on his part to induce the bank to take his contracts.

I have never heard of some of these other situations, people do not—dealers do not put cash in reserve accounts.

The Court: What is your question again?

Q. (By Mr. White): The question is perhaps misunderstood. I didn't say, Mr. Simpson and your Honor, the dealer comes in with cash or, let's say, some highly secure collateral, bonds of the United States Government, and puts them on deposit with the bank and says "Here you put this in your bank as security for my obligations either on loans I make or on conditional sales contracts which I sell to you. I authorize you to deduct from that cash or from those bonds any default, any payment—where one of these refunds with time price [68] differential, if there is any, repossession, anything of that sort which I am liable or obligated to you for, withdraw from that cash or debit this account."

That is what we are assuming, a physical deposit of either cash or high-grade security.

The Court: And then your question is, if that were done, would the bank insist on withholding this $67.25 in a reserve, or would it pay that amount out at the same time that it paid the great bulk of the contract at the beginning?

(Testimony of Russell H. Simpson.)

Mr. White: Exactly. That is my question, your Honor.

The Court: Well, again the witness is in a difficult position, because he says that it is never done.

Q. (By Mr. White): I will ask you: Would there be any purpose in crediting a reserve under those circumstances?

A. Well,——

Mr. Hankins: I still object to that type of questioning. The witness has stated time and time again that they don't do that, and how can he conjecture and say what they would do if they have never done it before?

Mr. White: We are testing the theory of this, and if he knows the theory and reasons for it, he could then tell us if there is any reason for crediting under those [69] circumstances.

Mr. Hankins: I think we are actually talking about what they actually do in this particular controversy, the petitioner, what he did in this situation and what the bank does generally, and I think that controls our issue in this case, what were the actual facts here, not what could have happened or if something else had been in issue, or some other factual situation had been presented, but I can't see that that has any bearing or relevancy on the issues in the case at hand. I think only the facts in this particular case are in issue, without any conjecture. That is too far-reaching.

Mr. White: I might add this witness is classifying, he is concluding. He says "this is a sharing in

(Testimony of Russell H. Simpson.)

the time price differential." He says "this comes from time price differential, and it couldn't ever—doesn't come from the contract balance."

The Court: That is the reason, of course, I have been allowing the examination thus far. I will permit the witness to answer; if he doesn't know the answer, he can say so, or if he wishes to say what would be his view of what would happen, as an expert on these matters, he may answer that, understanding all the while that those are not the facts in this case.

Can you answer that, Mr. Simpson?

Mr. White: Perhaps I could restate the question. [70]

Q. (By Mr. White): My question was: In these circumstances, would the bank have any reason or purpose in crediting a dealer's reserve account?

A. Let me try to explain it this way: My business is a business of decimal points and documents and balances. For every debit there must be a credit, and so forth, so all I can go on is how I know use and custom to be within this particular type of business I am in. If we were going to take a guarantee that was substantial, a dealer who had a net worth way up in six figures and he had stock or bonds, or something like that, we would probably continue a guarantee and put it in the file.

Now, this is actual practice, knowing him to be honest and reliable and a man of some background within our own community, we would then take his

(Testimony of Russell H. Simpson.)

continuing guarantee and let him keep the stocks and bonds and we still insist he set up the reserve from the contract and any losses that would go or above his credit to the reserve account, we would call on him to pay off on those losses from his personal resources or from his company or corporation.

Now, that is actual practice.

Q. You say you would do that, even though he did deposit with you a sum of cash which is more than enough to take care——

A. Well, as I said—— [71]

Mr. Hankins: I don't think he said that.

A. (Continuing) ——we would ask the man to keep his reserve account with us intact and the balance entered at all times so, No. 1, we could charge refund on prepayment and would have to have some place to charge them, you see, and, No. 2, if he were not available or in case of demise or sickness or he had a judgment against him, an attachment, or we could go on for a number of reasons, we would still want something under our control so that we could say "these are the inducements that caused you to come in our bank and discount contracts with us.

"And should we suffer a loss, then we have an account to charge those losses to until such time as we can recover from you."

Q. Can you charge to losses to an account which is—which represents a sum of cash, if he deposits cash with you?

(Testimony of Russell H. Simpson.)

I suggest he deposit a million dollars in cash. Using that sum, wouldn't the bank make this entry, debit cash, one million dollars, credit accounts payable one million dollars?

When there is a default, whether it is this man's obligation——

A. In actual practice, we would have to have some guarantee in writing, such as a form of continuing guarantee, or some other agreement, perhaps like this, whereby we could [72] recover under the bank right of offset and we would insist on that dealer having a reserve under our control.

Q. Why wouldn't the cash on deposit be in your control?

A. It could be within the limits of any agreement, such as we have here, or that continuing guarantee, but we would still be subject to judgment, suits, and so forth.

The Court: I think maybe we have pursued this far enough. I take it, Mr. Simpson, you are saying you could have most any kind of an agreement that you wanted to with a dealer, if he wanted to put up a large cash deposit and agreed, you could charge losses against that, it could be done theoretically?

The Witness: Theoretically only.

The Court: I understand that, but I take it that is what he is asking you, it would be possible to do it if the parties agree to it?

Q. (By Mr. White): And my next question, Mr. Simpson: If that were the case, would there be

(Testimony of Russell H. Simpson.)

any purpose in the bank insisting on dealer's reserve of credit every time they purchased a contract from him?

A. It's my personal opinion, as I said here, as an employee of the bank, we would insist on a reserve to the extent of override on the charges. [73]

Q. What would be the purpose of that?

A. I just mentioned those reasons.

Q. I didn't get your reason. I will ask the reporter to——

A. We didn't strictly under our control without having to contact anyone to see whether or not they would agree that we would charge this reserve account.

Q. That is where you vary the facts.

We assume a case, say he gets a blanket right to debit that account at any time——

The Court: We don't want to argue, of course.

The Witness: We would, I assure, insist on reserve. We have no exceptions on that in our bank, at least, and that is all I can talk about, what we have in our bank. There is no exception to that rule in our bank.

Q. (By Mr. White): Referring again to this matter of sharing the time price differential, is the bank sharing in the time price differential or is the bank merely earning its discount rate—I will put the question again. I will give a preface. This is a bit complicated and I feel as though these prefaces are necessary.

The Government's contention is the bank earns

(Testimony of Russell H. Simpson.)

the discount which is, in this case, approximately four and a half per cent, not the time price differential, so my question to [74] you is this: Is there a sharing between the bank and the dealer in this sum of interest known as time price differential or does in fact the bank merely earn its discount, namely, four and a half per cent, and does not share in the time price differential?

A. The answer to that would probably have to come in two parts, conceivably as written on the blackboard——

The Court: Of course, you are asking this witness for a conclusion on the question involved in a case, are you not?

Mr. White: I suppose I am, your Honor, yes.

The Court: I think we are concerned with the basic facts, and I think some of my questioning brought out some of the basic facts of what the bank charges and what the bank is entitled to.

Would you care to withdraw that question?

Mr. White: I think I will withdraw the question.

Q. (By Mr. White): Referring now, Mr. Simpson, to the payments, the time price differential which is no longer due when the purchaser pays off the contract prior to maturity, will you first state to the Court: is there a cash sum which is refunded to the purchaser under those circumstances?

A. If he pays it out before its maturity, well, it wouldn't be a cash sum, the refund would be deducted from the— [75] from his unpaid balance.

Q. Am I correct, you would merely reduce the

(Testimony of Russell H. Simpson.)

sum still unpaid? A. That's right.

Q. The bank in that circumstance, as I understand your testimony, would debit the dealer's reserve account for a portion of that sum which is no longer collectible from the purchaser.

How does the bank determine what portion to debit, how much to debit?

A. We do it on the percentage basis for the time that the money has been outstanding, the term of the loan based on what the bank earnings are.

Q. By "earnings," whose earnings?

A. The bank's earnings.

Q. Is there a formula known in advance which is used for that determination? A. Yes.

Q. If it is not complex, would you explain it to us, Mr. Simpson?

A. Rebate schedule for installment loan charges. In this particular case, I think this contract we are talking about, we refunded based on a prepayment of six months on a ten months—fifteen months contract. A fifteen months contract is paid before the sixth installment is due, we would [76] refund 37½ per cent of the time sales markup.

Q. How is the 37½ determined, why that percentage?

A. That percentage is determined by those analysts who figure earnings on a consumer loan or installment loan, installment loan charges as prepared by the consumer credit department of the American Bankers Association.

Q. It is not, then, based on the percentage of the

(Testimony of Russell H. Simpson.)

time price differential that originally was credited to the reserve account? A. No.

The Court: I am not sure that I have that entirely straight. We know that the bank has a certain percentage charge based upon this figure in the example of $1416.15.

Now, if the time comes that the purchaser of the car pays up in advance, the bank is certainly going to relinquish some portion of the time price differential that it is entitled or would be entitled to receive if it went to maturity?

The Witness: That's right.

The Court: Now, in a situation—that figure of $143.15 could be a very variable figure, depending on what the dealer wants to charge, as I understand?

The Witness: That's correct.

The Court: Do you at the time of prepayment of one of these accounts by a purchaser of a car figure the [77] amount of the dealer's share of the reserve which is to be refunded, which was originally credited to the dealer's reserve? You figure that at the same time, also?

The Witness: Yes.

The Court: And at the same rate and by the same table?

The Witness: By the same table we would rebate to the customer on the $143.15, that would be what our rebate would be figured on and whatever that happened to be in this particular case—I don't see the figures on the board, $44.20. The $44.20 in this

(Testimony of Russell H. Simpson.)

case would be the refund to the purchaser. Now, then that $44.20 refund must be shared by the bank and by the dealer, so there would be, then, $22.83 charged to the bank's unearned discount account and it would have $21.37 charged to the dealer's reserve account, meaning then those figures below indicate it would have $40 earned—$48 earned by the bank and $45 earned in the dealer's reserve.

The Court: To make it somewhat simpler, taking the actual figure there of $143.15, which was—which is denominated time price differential, you had previously set up $75.90 as the bank's charge based on the percentage of the figure, contract balance, $1416.15, then when the contract is paid up in advance of maturity, you apply your rate to your share, the $75.90, and figure how much you will have to refund to the customer, which will of course leave you a [78] lesser earning, lesser amount earned, than you might have expected had it gone to maturity and the other figure, $67.25 which has been previously put into the dealer's reserve, and that could have been a variable figure depending upon the rate charged by the dealer, you would apply your same table to that and forego the collection of any more. There is no refund involved, is there? You haven't collected this full amount of $143.15, isn't that true, you haven't collected it at this point?

The Witness: We have collected a portion of it.

The Court: You have collected a portion of it, all right. Would there still be some refund or would

(Testimony of Russell H. Simpson.)

it be a matter of simply foregoing collecting of any further amount?

The Witness: No refund, credited to the unpaid balance of the contract, $44.20, as you will notice on the blackboard, where it says "Unearned discount."

The Court: That is right.

The Witness: Now, over on the dealer's share, that $67.25, when the $44.20 is broken down in to the bank's share of the refund and the dealer's share of the refund, there still is a difference of only a couple of dollars between the two, so the remaining equity—it remains equitable all the way through.

The Court: I don't understand where we get the matter of refund when the customer hasn't paid the $143.15. [79]

The Witness: Because it was added in his contract for the full term of the loan, that was the charge for the full term of the loan. If the loan doesn't run the full term or, in this case, runs less than half of the loan full term, he is entitled to a part of those charges. If he pays in six months, he should get approximately nine months refund on charges. If we couldn't collect the same amount of discount, we would charge for fifteen months.

Q. (By Mr. White): Upon the payment prior to maturity by one of the purchasers, the dealer's reserve account is not necessarily *debted,* the dealer may come and pay a sum in cash directly to the bank equal to his share. What I was trying to de-

(Testimony of Russell H. Simpson.)

termine is if in the circumstance we were discussing, a payment prior to maturity that there is necessarily a *debt* to the reserve account. I am asking, if instead of a debit the dealer might come and pay the bank in cash?

A. Generally when an account is paid off, either another dealer who has taken the car in trade or pays the car off, or the customer himself pays the car off, and the dealer doesn't know it is being paid off at all until he receives charge to his reserve account, then generally that is the first he knows.

Q. I will suggest something else: In the case of a default where there is a sum unpaid and uncollectible and [80] the dealer is liable to the bank as guarantor, now, the bank could either debit the dealer's reserve account or could demand a sum of cash from the dealer to make good his guarantee; is that correct?

A. In the case of a repossession, we would figure the same kind of a pay-off that you see on the blackboard. That is, No. 1, we would refund the unpaid portion of the charges, we would charge his reserve for his share and then we would have the net pay-off which we would take a dealer's check for.

Q. Supposing the dealer's credit reserve balance is not enough—not sufficient to take care of his portion, he could come in and pay off in cash?

A. Couldn't. That's another thing that just doesn't happen in a bank. We just don't let that happen.

(Testimony of Russell H. Simpson.)

Q. In your testimony you stated that the credit to the dealer's reserve does not represent a fund. With that the Government has no quarrel, but the Government wants to ask you this question: The credit to the dealer's reserve does represent a liability of the bank to the dealer, does it not?

A. Potential liability.

Mr. White: Would you repeat that answer, please? Will the reporter read it back?

(Record read.) [81]

Q. (By Mr. White): You injected the word "potential." Isn't it a fact that unless there is a default and the bank—the dealer does not make it good by payment in cash, unless the contract is not paid off——

A. There is a liability control by the bank. It isn't a direct liability by the bank. In other words, if there is a deposit reserve account with, say, a savings deposit or a checking account deposit, which is paid on demand, it differs from the reserve account because it is paid on demand and the reserve account is not payable on demand, a reserve account is not subject to Exhibit 2-B, something of that nature.

Q. Assuming the instance we have here where there has been a credit to the dealer's reserve of $67.25, assuming there had been no other transactions with this dealer, that is the sole contract assigned and purchased by the bank, one moment after purchasing that contract the bank for some

(Testimony of Russell H. Simpson.)

reason of its own decides to forgive the purchaser and it does?

Let's assume the purchaser is no longer obligated to pay the bank, the bank forgives, and there is no further deal contemplated by the bank and the dealer cannot—the dealer insists the bank pay it $67.25 at that moment?

A. For such an example, I wouldn't want to get into it. [82]

Q. I am trying to illustrate this point, Mr. Simpson: The $67.25 is owed to the dealer by the bank and must be paid to the dealer unless certain things happen. For example, a default by the purchaser, a premature payment by the purchaser or the dealer enters into some kind of loan agreement with the bank and hasn't paid off. Unless those things happen, the dealer has to pay—the bank has to pay the dealer $67.25 that it is obligated to pay?

A. The bank is obligated to pay $67.25 to the dealer when one of two things happen: 1, the contract is paid off by the purchaser; 2, when the contract is paid off by the dealer. Then when the contract is paid off, it's paid off. In any event, that $67.25 belongs to the dealer.

The Court: If any one of those things happens, you mean?

The Witness: Yes.

The Court: Very well. I think that is enough on that.

Q. (By Mr. White): Again I have to ask you

(Testimony of Russell H. Simpson.)

a question because some remark was made on direct that this reserve credit was subject to other computations before payment to the dealer.

Well, the Government contends that isn't necessarily so. There might be a default, but if the dealer comes and pays that default by direct cash payment, there is no need for [83] any computation to be made.

So I ask you that question: Is there necessarily a need for any computation before payment by the bank to the dealer immediately after a contract is assigned to the bank, assuming there is payment, say, by the purchaser, all you need do is determine what sum is no longer collectible under the time price differential and then the dealer says "I will have no further business with you. I am going to withdraw any further negotiations." You are obliged to pay him the $67.25, less that portion of the unpaid time price differential?

A. I assume——

Mr. Hankins: Could we have that read back?

Mr. White: I will restate the question.

Mr. Hankins: It seems like that question got out of hand.

Q. (By Mr. White): We have this contract that you have credited to the dealer's reserve of $67.25 and the same day the purchaser pays the contract in full. You would then debit the reserve with the portion of the time price differential which is no longer collectible, is that correct?

A. We would. That portion of the dealer's re-

(Testimony of Russell H. Simpson.)

serve would be part of the refund to the customer because of prepayment.

Q. All right. [84]

Assuming there is a balance in the credit, a balance in the dealer's reserve and the dealer says "I do not intend to sign any more contracts with you. I would like to terminate our dealings. Please refund my credit balance from the dealer's reserve." Are you obliged to refund him that credit balance?

A. We would refund to him any portion of that reserve that exceeded our 10 per cent requirement, less 35-day accounts, less repossessions.

Q. As interest is earned by the bank, is there any entry made to that dealer's reserve account?

A. As you put the question, no.

Q. So that it is possible that an entry—that an entire contract may be paid off and the full time price differential paid to the bank by the purchaser and there would still be no entry to the dealer's reserve account? A. That is entirely possible.

Q. Under those circumstances, the bank would have reported as interest income from entire discount—— A. The bank discount, yes.

Q. I might also add that in addition there is no payment made by the bank to the dealer under those circumstances, no cash payment?

A. No. In this case, that $67.25 would help the dealer build equity in his reserve so that whether he [85] exceeded his 10 per cent requirement, he could draw some money.

(Testimony of Russell H. Simpson.)

Q. Now, under those circumstances, the credit balance is not necessarily going to be in excess of 10 per cent of the remaining credit balances?

A. Not necessarily, but as I understand, the Government is trying to prove something here. Actually, when the dealer ceases his business, then there is contingent liability and set rates, these decreasing amounts—it is easy for the dealer to get equity in his reserve above the 10 per cent.

Q. In case you want to clarify yourself—your answer—I was trying to show in this particular contract the bank, which is on an accrual basis and the partnership which is on an accrual basis, in the case of the bank the entire time price differential which it receives as its portion would have been reported as interest income, so there has been full payment, but the partnership may not have reported any of this so-called interest as income under the circumstances I have outlined.

So my question is, again—correct me if I am wrong—is it not correct that in this particular instance where the time price differential is $143.15, it is possible that the entire contract was paid, the entire time price differential was paid and the bank reports an interest income [86] of $75.90, and at the same time there has been no payment to the dealer out of his dealer's reserve account?

A. No payment whatsoever. All payments to the dealer are based on his excess in his reserve account over our 10 per cent requirement.

Q. Is it correct that the dealer's reserve account

(Testimony of Russell H. Simpson.)

is subject not only to his liability as guarantor under the conditional sales contract, but also subject to any other liability he may incur with the bank? A. Yes.

Q. For example, if he were to come to the bank and say "Loan me $10,000" and the bank did so, his obligation to pay that $10,000 would be—the dealer's reserve would be security for that obligation?

A. No, it would not be security for that at all, but it would be held in case of a problem with the borrower, we would probably hold the reserve.

Q. If he didn't pay the ten thousand at maturity, could the bank debit the dealer's reserve?

A. Yes, under the banker's right of offset.

The Court: That would be a right of offset, rather than a condition of the contract. That is not in the contract, is it?

The Witness: No.

Mr. White: I might clarify, your Honor. Exhibit 2-B states, and I will quote from paragraph 15: [87]

"Banks may retain from the proceeds of each contract purchase hereunto agreed upon amounts and the accumulated total of said amounts shall be retained by the bank in the dealer's reserve account as security for any and all obligations for dealer to bank."

The Court: I take it, then, the contract speaks for itself. You are speaking from memory and if

(Testimony of Russell H. Simpson.)

there is some provision there, you will change your testimony?

The Witness: Just what are we talking about here? Some of it I missed. As I remember, you were talking about unsecured loans of ten thousand dollars that wasn't paid. This agreement would not cover that.

Q. (By Mr. White): Then, would you explain why your answer, in light of paragraph 10, which states at that time the reserve, the security in the dealer's reserve account, is security for any and all obligations of dealer to bank?

A. Well, primarily that is referring—every major dealer, I do believe, in the used car business also has a flooring line in connection with the automobile business, so this contract would involve all the contracts that had been made by buying and selling automobiles, both floor and contracts—flooring and contracts.

Mr. White: No further questions, your Honor.

The Court: Any redirect examination?

Mr. Hankins: Your Honor, I would like to make a motion to strike all of the testimony of the witness dealing with the assumption that the dealer would bring in a large sum of money and deposit, which they could then or might charge against—to these charge-backs, instead of the way the bank handled it in this particular case.

The Court: Your ground is it is immaterial, irrelevant?

(Testimony of Russell H. Simpson.)

Mr. Hankins: Irrelevant and immaterial in this particular case.

The Court: You don't deny the competency of the witness to answer?

Mr. Hankins: It is something out of his purview, I would say, and it doesn't—he doesn't set down policies of the bank.

The Court: I understand that, however, I will deny the motion, it may have some bearing, may be of some help to the Court. I will determine whether it is material at a later date.

Redirect Examination

Q. (By Mr. Hankins): Mr. Simpson, are you—are any dealers ever asked to put money into the reserve account? A. Not to my knowledge.

Q. If a dealer—Strike that.

If a party that is not a dealer brings a contract to your bank covering the sale of a car on a conditional sales contract, would you charge that non-dealer the same amount of the time price differential portion as you would a regular dealer?

A. We would charge a higher rate.

Q. A higher rate than you would charge the dealers? A. That's right.

Q. Generally why would you charge a higher rate than you would a dealer?

A. The dealer brings in contracts, brings his contracts in to us in certain volume, depending on the dealer, and he is entitled to more consideration rate-wise than the individual purchaser.

(Testimony of Russell H. Simpson.)

The Court: Because of the volume of business he brings you?

The Witness: That is right.

Q. (By Mr. Hankins): In other words, then, part of the consideration for his bringing these contracts to you is that you give him part of the finance charge that ordinarily you wouldn't have gotten from a non-dealer without sharing with the non-dealer?

Mr. White: Your Honor, counsel didn't want me— [91] restricted me in cross-examination, and I must insist he not put words in the witness' mouth.

The Court: I agree. Let counsel rephrase any question he wants to ask.

Q. (By Mr. Hankins): The non-dealer, then, if he brings a contract to you, would you not share in the time price differential?

Mr. White: I object, your Honor, the phrase "share"——

The Court: I agree with counsel for the respondent. You are asking the witness for a conclusion on the question, as I understand it.

The Court is going to have to pass on the question of whether they are sharing in something or whether the bank is making a charge and the taxpayer is making a charge.

Mr. Hankins: I will rephrase.

Q. If a non-dealer were to bring a contract to you at the same figures that we have above here on our typical transaction, would you give him any-

(Testimony of Russell H. Simpson.)
thing else for that contract over and above what your normal discount rate would be non-dealers?

A. By that contract, at our direction, direct bank rates to individual purchasers, which would be at 6 per cent, and there would be no other credits other than to your unearned discount. [91]

Q. In other words, you would not set up any portion or any reserve for this particular non-dealer? A. No reserve set up.

The Court: May I ask you this: Are you speaking now of a case where this particular individual came in and guaranteed the account to the bank, counsel?

Mr. Hankins: I might bring that out, your Honor.

The Court: If you will.

Q. (By Mr. Hankins): If a non-dealer were to bring to you a contract similar to, with the same identical figures on it as we have on our typical transaction, would you ask him to guarantee that paper?

A. When this person referred to as a non-dealer, would he be other than the purchaser of the contract?

Q. One other than the purchaser.

A. The purchaser of the automobile?

Q. One other than the purchaser of the automobile.

A. No. If another dealer who was not on our books under a dealer's agreement, dealer's reserve, brought us a contract, first of all, we wouldn't take

(Testimony of Russell H. Simpson.)

his contract, we would tell him we would buy the paper if the customer would come in with his order and then we would write the contract from our bank at our rate of interest to a consumer.

Q. And would that rate of interest be greater than [92] you charge to dealers?

A. Yes, it would.

Mr. Hankins: That is all, your Honor.

Mr. White: No further questions, your Honor.

The Court: Thank you, Mr. Simpson.

(Witness excused.)

Mr. Hankins: I would like to call one other witness, your Honor, the petitioner in this action.

ARTHUR V. MORGAN

called as a witness on his own behalf, being first duly sworn, testified as follows:

Direct Examination

Q. (By Mr. Hankins): Mr. Morgan, are you the petitioner in this action? A. I am.

Q. Were you a partner in the Art Morgan Motor Company partnership in Long Beach?

A. I am.

Q. During the year 1950 did you arrange with the Farmers & Merchants Bank to assign to them various conditional sales contracts covering the retail sale of used cars?

A. I believe I arranged for that in 1946, which extended through a period of 1950.

Q. What was the purpose in arranging this

(Testimony of Arthur V. Morgan.)

financing with the bank, Mr. Morgan? [93]

A. Well, to sell contracts to them.

Q. Was it for the purpose of facilitating sale of your automobiles?

A. I had to have financing or I couldn't operate. In other words, it was to carry on my business.

Q. When these conditional sales contracts were entered into covering the sale of these used automobiles, were they made subject to credit approval?

A. They were.

Q. And who checked the credit?

A. That I don't know, some official in the bank.

Q. The bank did it?

A. The bank did it, yes.

Q. Then, after the bank checked the credit and okayed it, you completed the sale, is that the way it was handled?

A. The sale would be completed when they okayed the contract.

Q. Generally how soon after the purchaser agreed to buy this car, and the paperwork was completed on the purchase in your office, was it before you assigned it to the bank, Mr. Morgan?

A. Well, conditions varied there. We would have a purchaser that would make a—say, give $100 down payment and sign a contract and all the necessary papers, and then we would hold the contract until he brought in his additional [94] down payment, and then we would take it to the bank. Some would even come back and go through a

(Testimony of Arthur V. Morgan.)

credit union or their own bank, or something, and pay us in full. But that would vary, too, in the time that he signed the contract and the time that the contract reached the bank, that would depend on how quickly he completed his down payment.

Q. Mr. Morgan, how long have you been in the used car business?

A. Well, I started—I believe in December, 1946, the first time—I mean the last time, pardon me.

Q. Has your income tax return for any previous year ever been examined?

A. They have by the agents. In fact, I was examined in '47 and, I believe, in '49, and they went to the bank, I believe, the investigators then. The first one was named Harris and the last one was named Greenberg. And if I hadn't drawn out any excess reserve by the end of the year, I had to pay on it.

Q. In other words, in some of those previous years, I gather the same issue arose as to the dealer's finance reserve?

Mr. White: I object to this. I don't see the purpose of what happened in prior years. The Government might, for the purpose of argument, concede the agents didn't do their job, I see no purpose in this testimony. [95]

The Court: I don't think it has any bearing. Of course, the Court is concerned in the proper answer as to whether the Government or the taxpayer might have made a mistake, but something in prior years isn't of too much concern here.

(Testimony of Arthur V. Morgan.)

The Witness: Your Honor, may I say one word?

The Court: Let your counsel.

Mr. Hankins: Your Honor, the purpose actually is somewhat of an equitable situation. I think in this case if I may explain to the Court, in prior years this man was examined and this same thing was in issue. He spent some time going over it with the agents, two of them, in fact, and finally agreed with them that he would pay on his income, in this particular matter, of setting up into income the excess of the dealer's finance reserve over the 10 per cent limitation which he agreed was available as a constructive receipt.

The Court: I take it, the Government is now saying that that is not proper.

Mr. Hankins: They are now taking an adverse position and the taxpayer has been put in quite a burdensome situation in trying to go back and revamp some of these years. If the Government takes this attitude, establishes it is going to be adverse, take an adverse stand on some of the years, we will not then get the benefit for some of the years [96] that have elapsed in the meantime, and by handling it in this particular manner, due to some net operating losses, carry-backs involved in the situation, and I think that some as far as equitable issues are concerned, I think it is relevant.

The Court: I don't know just any equitable questions raised in the case. As I understand, the Government is claiming there is only one way to

(Testimony of Arthur V. Morgan.)

do this here, that the way you described it, the taxpayer—what the taxpayer did was wrong, and that is the issue before the Court.

Now, if there aren't any issues raised by the pleadings for any other years, all I can say is I guess it is my duty to decide what is right for this year.

As you know, taxable years are separate under Supreme Court decision, and it is possible that the Government might have been wrong in those other years, or it might have been a concession. On the other hand, the taxpayer may have been right in those years, I am not prepared to say at this moment, but I don't think what was done in prior years will influence the Court here in determining the proper answer for this year.

Now, if there is some complications that arise as a result of the decision of the Court, perhaps the parties can get together and try to iron out the difference, if there [97] are any duplications or anything of that nature.

Would there be any, counsel?

Mr. White: I know of none, your Honor. I think this is the first time I have heard of this equitable argument.

Mr. Hankins: Not in the pleadings, your Honor. My main purpose in getting this before the Court, generally the Tax Court never sits as an equity court, and I think your higher courts do and if the decision is in the Government's favor, then we would like to interject this in our appeal. So that

(Testimony of Arthur V. Morgan.)

is the reason I want to get the issue in. If you rule it out——

The Court: I am putting it in for whatever it might be worth, I am merely saying that as far as this Court is concerned, I don't see how it will affect our decision.

Now, have you asked all the questions you want to on that subject? There is that motion to strike—is that a motion from the Government's counsel or what?

Mr. White: I make a motion, your Honor, to strike any testimony regarding what any agent did in prior years in auditing returns of Mr. Morgan or any partnership which he was a member of.

The Court: Well, it is already in evidence now. I will deny the motion to strike, although, I must say at the moment I fail to see any relevance, but that is something that [98] can be decided later when the case is decided.

Mr. Hankins: I will ask one other question.

Q. As a result of prior examination in prior years in which this was an issue, what method did the agent use at that time to tax the dealer's finance reserve as income? Do you know, Mr. Morgan?

A. They checked directly with the bank to determine whether I could draw anything over the 10 per cent plus the bad accounts.

Q. Then, the excess they then determined was tax income to you? A. That's right.

Q. Did you agree to that? A. I did.

Q. Did you pay your tax? A. I did.

(Testimony of Arthur V. Morgan.)

Mr. Hankins: No further questions.

The Court: Cross-examination?

Mr. White: No questions, your Honor.

(Witness excused.)

Mr. Hankins: Your Honor, may we have permission to submit consecutive briefs in this?

The Court: Off the record.

(Discussion off the record.)

The Court: On the record. [99]

Is it agreeable to counsel to submit seriatim briefs?

Mr. White: That is agreeable.

The Court: What time would you like?

Mr. Hankins: Forty-five days would be sufficient, sir. I would like permission to file first.

Mr. White: I would like thirty days after the forty-five.

The Court: And you want time for reply briefs, do you?

Mr. Hankins: Yes, sir, I would like thirty days, if possible.

The Court: Very well. Forty-five days for the taxpayer's brief, thirty days thereafter for the respondent's brief and thirty days thereafter for the petitioner's reply brief.

The case will stand submitted awaiting filing of briefs.

The Clerk: Those days, gentlemen, are February 25, and thirty days thereafter will be March 27, and thirty days thereafter will be April 26, 1957.

(Whereupon, the hearing in the above-entitled case was closed.) [100]

[Endorsed]: T.C.U.S. Filed Feb. 1, 1957.

[Endorsed]: No. 15898. United States Court of Appeals for the Ninth Circuit. Arthur V. Morgan and Dorothy O. Morgan, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: February 11, 1958.

Docketed: February 21, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.

In The United States Court of Appeals
For The Ninth Circuit

No. 15898

ARTHUR V. MORGAN and DOROTHY O. MORGAN, Petitioners On Review.

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent On Review.

STATEMENT OF POINTS

Now comes Arthur V. Morgan and Dorothy O. Morgan, the petitioners herein, by their Attorney, Leonard B. Hankins, and hereby asserts the following errors, which they intend to urge on review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court of the United States in the above cause on October 17, 1957.

1. The Tax Court erred in that it held that amounts retained by the purchaser of an automobile dealer's deferred payment contracts and credited to a reserve account on the books of the purchaser to be accruable income to the dealer in the year of sale of the contracts even though the amounts of the reserve at the close of the year was not sufficient to allow the dealer to demand payment of any part thereof.

2. The Tax Court erred in entering its order and decision that there is a deficiency in petitioners income tax for the Calendar year 1950 in the amount of $4,076.40.

3. The Tax Court erred in that its decision is not supported by the evidence.

4. The Tax Court erred in that its decision is contrary to the law.

/s/ LEONARD B. HANKINS,
Attorney for Petitioners on Review.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed February 21, 1958. Paul P. O'Brien, Clerk.

[Title of Court of Appeals and Cause.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

To the Clerk of the United States Court of Appeals for the Ninth Circuit:

The following is a designation of the Contents of the Record in the above proceeding which is necessary and material to the Consideration of the review of the United States Tax Court Decision in this matter which is being appealed to your Court.

1. Docket entries in this proceeding;

2. Petition.

3. Answer.

4. Stipulation of Facts with Exhibits 1-A through 6-F attached;

5. Official Report of Proceedings before the U. S. Tax Court;

6. Findings of Fact and Opinion of the U. S. Tax Court;

7. Decision of the U. S. Tax Court;

8. Petition for Review of the U. S. Tax Court Decision;

9. Proof of Service of Petition for Review;

10. Designation of Contents of Record on Review;

11. This Designation of Contents of Record on Review.

/s/ LEONARD B. HANKINS,
Attorney for Petitioners on Review.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed February 21, 1958. Paul P. O'Brien, Clerk.